RESEARCH

Economic Outlook

Europe

First Quarter 2012
Economic Analysis

- **The ongoing European sovereign crisis** and global slowdown will lead the eurozone to a mild recession in 2012.
- **Successive European summits since October and the ECB's intervention served to gain time,** but further progress is still required...
- **...focused on the completion of the new fiscal treaty,** strengthening the liquidity firewall and reforms in the periphery.
- **Peripheral countries are in recession** due to the continuation of financial stress and severity of the fiscal adjustment.

Index

Closing date: February 10, 2011

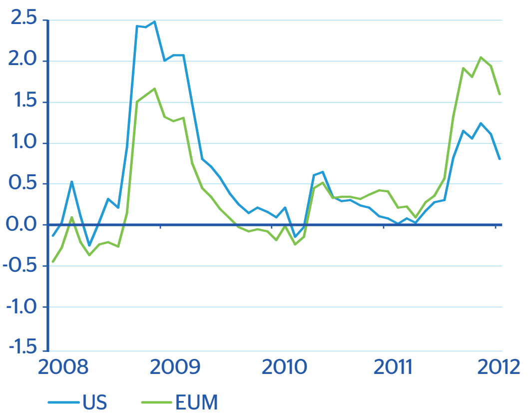
1. Global slowdown and recession in Europe

The global economy slowed at the end of 2011 but will rebound in the second half of 2012, led by emerging economies

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (with negative growth already in Q4) and the deceleration in emerging economies, to around 1% q/q at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration could not be more different in both areas. Europe is starting to feel the effects of persistently high financial tensions since September (Chart 1), given the lack of major advances to solve the sovereign and financial crisis. In contrast, the slowdown in emerging economies, apart from headwinds coming from developed economies, is partly the result of deliberate policy tightening until the first half of 2011, designed to avoid overheating.

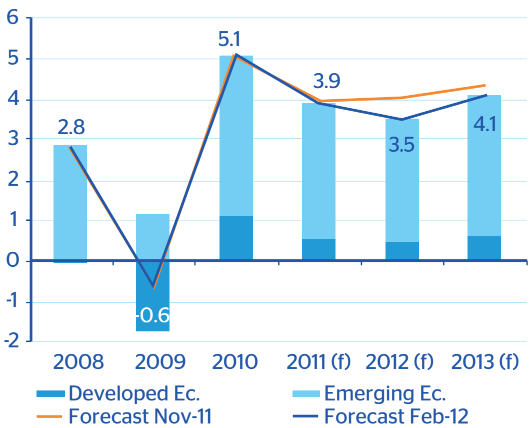
Going forward, we expect decisive actions by European authorities that will slowly lower financial tensions in Europe and also global risk aversion, conditional on a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their growth rates recover their historical differential of around 4 percentage points relative to those of developed countries and their policies turn more and more into growth-supportive mode. At the same time, even though the US will grow less than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The lack of decisive advances in the resolution of the European crisis still makes the eurozone the main risk to the global outlook

Even with the downward revision of growth rates in Europe and emerging countries, we still see risks to the global growth outlook tilted markedly to the downside. These risks continue to hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on the three main lines of action to solve the crisis in Europe. First, on the sovereign debt front, concerns about the solvency of Greece need to be cleared. At the same time, sizable and credible sovereign firewalls must be erected to avoid contagion to illiquid countries. Second, macroeconomic reforms should continue to be pushed forward to increase growth, including those aimed at repairing financial institutions' balance sheets but taking care to avoid a sudden deleverage and a reduction in credit to the private sector. Finally, further advances in eurozone governance are necessary to reinforce the monetary union, facilitating the implementation of sovereign firewalls and establishing a clear roadmap to a fiscal union.

In line with these three points, European prospects would be greatly improved if the agreed fiscal compact is finally approved at the national level and rapidly implemented after the March EU summit, together with economic reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth. Rapid implementation of that side of the implicit "grand bargain" between core and peripheral Europe will allow the discussion to pivot to two urgent measures to reduce sovereign stress in Europe. First, rapidly increase the resources available to erect a sovereign firewall around Greece, perhaps with a more decisive action by the ECB; second, take into account the negative effect of a weaker cycle on the ability to meet the agreed deficit targets in most European countries. These issues are dealt with in section 2.

Sustained financial tensions have pushed Europe into recession. The growth gap with the US will widen in the next two years

Financial tensions in Europe continue at higher levels than after the fall of Lehman Brothers in 2008 (Chart 1). This, together with the effect of fiscal adjustment in peripheral countries, imply a downward revision of our growth projections for Europe, and we are now expecting negative growth at least in the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. Nonetheless, it is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress, to avoid a sharper effect on growth. The divergence in performance between the core and the periphery in Europe will continue to be large, partly because of the large fiscal adjustment in the latter. Perspectives are presented in detail in section 3.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, this recovery is weaker than post-recession cycles, and is surrounded by the risks emanating from Europe and the domestic risk of high policy uncertainty, including a possible massive fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts related to the debt ceiling limit agreement are implemented automatically). In addition, weak housing conditions, tight credit markets and ongoing deleverage will limit the pace of consumption growth. All in all, we see more risks to the downside than to the upside in the US.

Emerging economies are heading for a soft landing, buttressed by strong domestic demand. Policies will become more growth-supportive going forward

One important aspect of the current crisis is that confidence has remained resilient in emerging economies, as opposed to the aftermath of the fall of Lehman Brothers in 2008. One possible determinant of this resilience is the surprising nature of the Lehman fall (mostly absent in the European crisis) and the different speed at which each one develops (the European crisis advancing in "slow motion"). This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets in the region, through lower capital inflows, some impact on trade finance, reduced asset prices and lower exchange rates.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, below the historical 4 percentage points seen since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will take advantage of existing buffers (including lower inflationary pressures and some fiscal space) and turn more and more into growth-supporting mode, in contrast with the tightening experienced in the first part of 2011. This will allow domestic demand to continue supporting growth in the region, in the face of external headwinds coming from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be concentrated on emerging countries in Europe, as they will be more affected by closer trade and financial links to the eurozone.

2. The sovereign and financial crisis in Europe pushes the region into recession

The European sovereign debt crisis continues unabated. Solutions after the December and January summits have been not enough

Since last summer, the sovereign debt crisis has become systemic within the eurozone, as contagion clearly spread to large eurozone countries such as Italy and Spain, which saw their sovereign differentials widening, and to the European banking sector, which had to deal with funding difficulties. According to our financial stress index, tensions in November reached all-time highs (Chart 1), well above the Lehman episode. Despite some easing in the past few weeks, market conditions are very tight (Chart 11) especially among sovereigns and the banking system.

The approach to solve the sovereign crisis in Europe has been since the beginning (May 2010) clearly partial and somewhat erratic. As we have mentioned in the past, there are three main fronts where EU authorities need to agree on crucial steps to end the crisis: (i) sovereign debt, (ii) reforms to promote a more balanced growth, and (iii) eurozone governance.

Solvency concerns still need to be dispelled, starting by solving the Greek issue...

The sovereign debt front has two main pillars: dealing with insolvency as well as liquidity problems. Greece's insolvency has been tackled too slowly, and has been probably exacerbated by a rescue programme that was too harsh on fiscal measures and by the fact that Greek authorities did not comply with its conditionality, or at least with the implementation of the measures agreed with the troika. In particular, the lack of results in the fight against tax evasion and in the efforts to raise fiscal revenues has been stark. This, together with continuous upward revisions of debt ratios, resulted in a debt ratio of 161.7% at the end of 2011, which made the situation unsustainable.

The second bailout programme agreed in October, which is key for avoiding a default in March, has not been closed yet. It depends on an agreement with the private sector that imposes a haircut of 50% and could entail a net present value loss of 70% or somewhat higher. This agreement is basically finished, and has been complemented with the recent announcement by ECB president Mr Draghi that the ECB is ready to forego the profits made on Greek bonds (which it bought at market prices), thus contributing to the new package. It also depends on the Greek authorities accepting all the conditions demanded by the troika, which seems to be on track despite social and political disruption. Still, this setup faces two key uncertainties. First, in the short term participation by the private sector may not be large enough, although it will possibly be achieved by the Greek government through the introduction of collective auction clauses to old debt. Second, in the medium term Greece may not be solvent even with full participation given a sharp recession, lack of implementation of effective measures and still pending large fiscal adjustments. This implies that in the coming quarters doubts about the possibility of another accident in Greece will not be fully dispelled, as Greece will still have to comply with the calendar of measures agreed with the troika, which will probably be less forgiving with slippages than what it has been in the past.

... and with continuing reforms, to reduce macroeconomic vulnerabilities in the rest of the periphery, as defined in the "Six-Pack"...

Market concerns regard also an eventual restructuring of debt for other countries. In our view, one major mistake by the EU approach to the crisis (or at least a decision with too many negative externalities) was to open the possibility of losses by private sector bondholders through the involvement. The EU agreed in December to drop the requirement that any future rescue by the ESM would necessarily involve the private sector (beyond Greece). This is positive, and is an implicit recognition that the Private Sector Involvement (PSI) in the Greek case was a mistake, but has not been enough to convince investors that they will not be called upon next time.

Market tensions are an additional signal that investors worry also about the fundamentals of other eurozone countries, but in our view such concerns are overdone. On the structural side, Italy is pushing for deep reforms in various areas and its public deficit is not too large. Spain is taking further measures, and its debt ratio is relatively low. The market focus is now on Portugal (see Box 5), which has been experiencing low growth over the past decade and has imbalances in many areas. However, even in that case the actions taken by the government have been bold, both on the reform of the labour market and in measures to achieve the fiscal consolidation demanded by the troika, and should continue to be sustainable even if the support from the EU and the IMF will probably have to be extended beyond 2013.

However, despite action is being taken on the reform side, the key is to continue the effort and deepen reforms in order to restore competitiveness and growth potential in peripheral countries, and in addition, to avoid the build-up of imbalances in the future. The initiative taken by the EU in the context of the Six-Pack (see Box 1) will be very important in this respect, as it has now become evident that the current sovereign crisis is partly a result of the accumulation of imbalances in the private sector, which were not under vigilance in the framework of the Stability and Growth Pact (SGP).

Box 1. Macroeconomic imbalances in the eurozone: what will the "Six-Pack" monitor?

One lesson from the deep recession of 2009 and the current sovereign crisis is the necessity of early detection and prevention from the creation of macroeconomic imbalances in member states beyond the usual focus on deficit and public debts. The European Commission announced recently, in the context of legislative initiatives known as "Six Pack", a list of various indicators to monitor continuously, during the newly created "European Semester", in order to detect excessive imbalances in the future. The variables include imbalances relating to private sector (private debt, credit growth, housing prices), the external sector (current account, net foreign debt), competitiveness (real effective exchange rate, unit labour costs, changes in the exports share), and unemployment rate.

The European Commission has established a set of thresholds for these variables that would trigger an in-depth analysis of the underlying sources of imbalances and a formal request for the national country to submit an action plan to correct them. This process is labelled as the "Excessive Imbalance Procedure" (EIP), and falls within the new philosophy of controlling all types of imbalances, and not only public deficit and debt.

Table 1 presents these variables for the main eurozone countries, in addition to public deficit and debt, as defined in the Six-Pack (in some cases averages over several years). We also graph those variables normalized around the European average, which is represented by a round circle at value zero. The units of the axes show the standard deviation from the eurozone average. Several divergences can be observed within members, in particular peripherals record substantial deviations from the average in several indicators out of the 10.

The divergence across countries is relatively large in some variables, especially those related to external debt and current account deficit, revealing differences in competitiveness. It can also be observed that the level of private debt is outside the range defined by the EU in many countries, and by a large amount, showing that cumulated imbalances of the private sector have been higher than those of the public sector. Table 2 summarises the main weakness for each major country and those in the periphery.

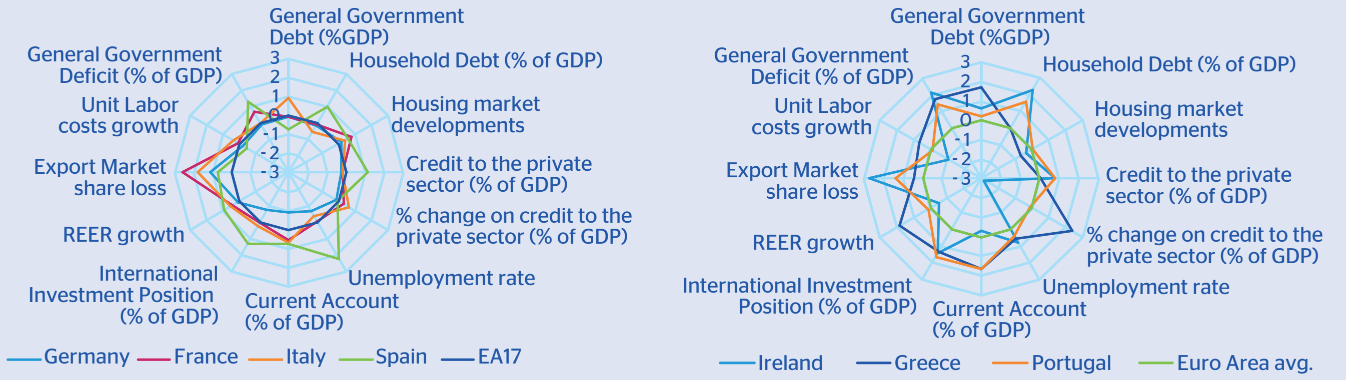
Table 1

European Commission 10 Indicators Scoreboard for selected EU members

	Domestic sector						External sector			Competitiveness indicators		
	Private sector debt	Private sector credit flow	General government debt	House prices relative to consumption deflator	Unemployment rate		International Investment position	Current account		Real effective exchange rate (REER)	Nominal Unit Labor Cost	Export market share
	(1)	*(2)*	*(3)*	*(4)*	*(5)*		*(6)*	*(7)*		*(8)*	*(9)*	*(10)*
Thresholds	*> 160% of GDP*	*> 15% of GDP*	*60% of GDP*	*+15% y.o.y*	*3 year moving average +10%*	*Last*	*-35% of GDP*	*3 year backward moving average-4% / +6% of GDP*	*Last*	*3 year % change +/- 5% for EZ/ +/-11% for non EZ*	*3 year % change 9% for EZ/ +/-12% for non EZ*	*5 year % change -6%*
Germany	123.8	-2.5	86.5	0.2	5.8	5.6	34.4	5.5	5.4	-7.0	5.9	-8.2
France	217.1	2.6	103.9	1.0	9.7	9.8	-10.0	-2.3	-2.5	-5.8	6.1	-19.4
Italy	162.7	2.1	105.2	-0.4	8.5	8.7	-26.6	-3.8	-3.7	-4.0	8.2	-13.3
Spain	280.9	-9.6	81.0	-2.4	22.0	22.8	-93.0	-4.3	-3.9	-4.0	8.3	-5.2
Greece	136.8	0.3	137.6	-9.5	17.6	18.4	-92.0	-9.8	-9.9	-0.4	2.4	-3.5
Portugal	253.2	-1.9	93.6	-5.0	12.8	13.3	-102.8	-8.9	-8.4	-3.7	5.3	-10.5
Ireland	370.3	-14.5	89.7	-6.8	14.4	14.4	-95.7	0.7	0.6	-13.6	-8.3	-20.5
Belgium	234.7	-1.7	110.8	-2.1	7.2	7.2	77.6	0.9	0.0	-3.5	7.3	-11.6
Austria	152.5	-1.2	84.6	-0.9	4.0	4.1	-9.8	2.7	2.6	-2.7	10.0	-10.5
Finland	86.5	1.7	46.0	0.7	7.7	7.6	14.5	1.4	1.1	-3.8	5.8	-26.9
Netherlands	245.4	1.0	72.9	-9.3	4.5	4.9	28.0	7.5	7.9	-6.7	5.3	-2.7
UK	218.0	-0.1	89.0	-8.0	8.1	8.3	-16.4	-2.9	-2.9	-13.8	5.2	-29.9

Note: Last refers to the latest observation available on quarterly basis
Sources: Haver through (1) (3) (6) and (7) National sources (2) ECB (4) (5) and (8) Eurostat (9) Eurostat or OECD and (10) IFS and BBVA Research

Chart 3
Macroeconomic imbalances



Note: Standard deviation with respect the normalized eurozone average in 2010 or 2011 depending on availability
Sources: National sources, ECB, Eurostat, OECD and IFS through HAVER and BBVA Research

Table 2
Country assessment on macroeconomic imbalances

Germany	No major imbalances are recorded, except for surpassing the general government level threshold, but by a manageable margin. The current account surplus is high, though the range defined in the Six-Pack seems to be fixed in order to avoid reconvening Germany for having an excess surplus and therefore not having to ask for stimulus measures.
France	The stock of debt for both the private and public sectors have been persistently above the established limits. While unit labor costs have been increasing moderately above the average, the loss in export shares is large.
Italy	High and persistent public debt, but private debt under control until 2009, when the threshold has been surpassed. The pace of growth of private credit has been smooth and house prices have risen by less than in other countries, showing no major bubble in the private sector. Regarding external indicators, the current account deficit has widened, unit labor costs have increased and export market shares have fallen, all of which reveal a moderate problem of lack of competitiveness.
Spain	Housing prices relative to CPI have registered negative growth recently showing signs of adjustment and approaching levels previous to the boom. Given the large increase in house prices in the past, the selection of indicators is probably not perfect (this variable will serve to identify future bubbles, but does not say anything on bubbles cumulated in the past). Private debt remains well above the required 160% of GDP level, but moderating particularly at the household and firm level, excluding construction, reflecting the process of deleveraging and the waning in credit growth. The level of government debt is relatively low. On the external side, the three year average current account deficit is still above 4% but correcting rapidly, however the international investment position is well above -35%. Export market shares, in contrast, have been declining relatively little. The unemployment rate is by far the major imbalance.
Greece	Government debt is the highest in the area, while private debt remains at sustainable levels, as credit growth was relatively high but has been correcting sharply since the beginning of the crisis. External indicators show a worrisome picture on competitiveness, as the current account deficit shows little correction while unit labor costs show signs of moderation in their pace of increase, but still at positive rates. The net external deficit is high at -95% of GDP.
Portugal	Private sector indebtness is huge at 253% of GDP, reflecting the low level of savings. Public debt has increased recently, although is below that of some other periphery countries; the public deficit is still high. The unemployment rate has registered a sustained increase reaching 13.6%. On the external side the current account deficit has fallen recently, but is still high, as is net external debt.

Source: BBVA Research

One important dimension of much-needed reforms concerns the financial sector. Here, the European Banking Authority increased capital requirements by 2012 as the first response once Spain and Italy were affected by market doubts. But it was the wrong approach in our view. First, it did not deal with the core of the problem in the eurozone (mostly sovereign debt, not banking debt), and it did not push for coordinated action on cleaning some eurozone banks' balance sheets. Second, applying haircuts to sovereign bonds in the calculation of capital needs increased market concerns on solvency issues, reinforcing the negative feedback running from banks to the sovereign. Lastly, in the context of closed markets for bank funding (which did not open up with these higher capital requirements), forcing a deleveraging without cleaning balance sheets intensified the risk of credit constraints and thus a recession in Europe.

Advances in eurozone governance are essential to fulfilling one of the targets of the "grand bargain"...

Further advances in eurozone governance are necessary to reinforce the monetary union. The "six-pack" and the European semester are important advances in this respect, but will not be enough on their own to ensure that future problems will be avoided. In this sense, EU authorities were expected to reach an agreement in December to reinforce fiscal discipline, but the details of the international agreement (excluding the UK and possibly others) were postponed to the March summit, killing hopes of more decisive ECB intervention in bond markets. More importantly, negotiations have not included a clear and credible roadmap to a fiscal union, with Eurobonds at its core.

In a broader sense, rapid advances in eurozone governance, including the approval and implementation of the fiscal compact and fast implementation of reforms in peripheral countries would greatly improve European prospects. Once that side of the implicit "grand bargain" between core and peripheral Europe is finalized, the discussion can then turn to two urgent measures mentioned above to reduce sovereign stress in Europe. First, increase the resources to finance a sovereign firewall around Greece, perhaps with a more decisive action by the ECB. Second, take into account a weaker cycle when evaluating the ability of most European countries to meet the agreed deficit targets.

...to be complemented by the reinforcement of the liquidity wall...

For solvent countries with liquidity problems, a sizable and credible sovereign firewall must be erected to avoid contagion. Just before the December EU summit, it was hoped that the ECB would intervene much more decisively in sovereign debt markets once the fiscal compact was approved, helping to definitely reduce market tensions. But it was not the case; instead, the ECB started its policy of lending unlimited liquidity at three-year auctions, which has been very positive to reduce funding concerns over the banking system and to ease spreads in the short end of the curve, but is not a definite solution to the confidence crisis. (see Box 2).

As for other liquidity firewalls, they are not for the moment up to the task. The intensification of the crisis has rendered all the schemes to leverage the EFSF obsolete, as spreads increased also in core countries in Europe. At the same time, its substitute (the ESM, whose implementation was brought forward to mid-2012) does not change things much, as the amount involved (€500 bn) is still not large enough to act as a liquidity "bazooka", and needs to be approved by all countries. The experience of slow implementation of the EFSF in 2011 is a bad precedent in this respect. Even adding the extra EUR €150bn approved by the EU for the IMF would not be enough to cover the financing needs of Spain and Italy for the next three years. A combination of the ESM, EFSF and shoring up the IMF funds within the discussion of the G20 could get closer to nailing it down.

... and by a less aggressive approach to fiscal consolidation

Concerns about the strong drag on growth created by large fiscal adjustments are increasingly being considered by peripheral countries and the IMF. So far, the response provided to this requests by the EU in the January 30 Council summit to this debate has been more verbal than real, pointing only to the possibility of using already available structural funds for this purpose. In our view, these fiscal adjustments should be discussed in the structural-cyclical deficit framework, in the sense that commitments already made to reduce structural deficits should be kept, but should not be supplemented by further measures if cyclical events lead to worse than expected fiscal outcomes. This would not avoid the fiscal induced recessions in several peripheral countries this year, but would help to escape a recession-adjustment spiral. Box 3 reviews past episodes of fiscal consolidation in other OECD countries, and shows that adjustments of the size being faced by many eurozone countries were rare in the past, and were mostly dealt with in a much better cyclical context.

Box 2. ECB: focus on avoiding a credit crunch by supporting banks' liquidity

After the unexpected cut of the main policy rate by 0.25pp to 1.25% in November on the materialization of downside risks to economic activity in a context of easing inflation concerns, the ECB further reduced the refi rate by 25 basis points to 1% in December, and more importantly, announced bold non-standard measures to avoid a tail risk event of strong bank de-leveraging in the eurozone. With the risk of a credit crunch, the focus was on the provision of bank liquidity to avoid credit tightening in a context where banks were facing serious funding pressures. Funding strains had reached critical levels –see Chart 4 with our Liquidity Conditions indicator for the eurozone– comparable with those seen in 2008Q4. Private debt markets were closed for European banks. Against this backdrop, the main central banks announced a coordinated action to ease USD funding conditions for European banks, while the ECB unveiled the exceptional measures previously mentioned to offer, in effect, unlimited lending to banks up to three years.

Three-year LTRO: removal of tail risk by providing abundant liquidity

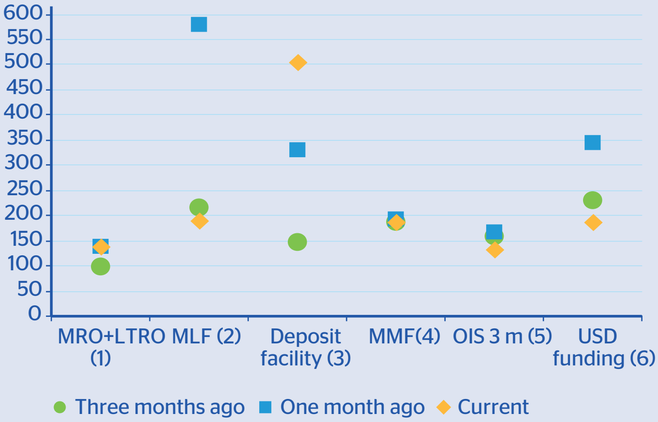
Amid the increasing risk of a credit crunch, and along with the second consecutive 25bp cut of the refi rate, at its December meeting the ECB announced bolder than expected non-standard measures to help banks (Chart 5). On the liquidity side, the ECB introduced two new three-year flexible[1] LTROs (longer-term refinancing operations). On the collateral side, the ECB announced a more flexible collateral policy in order to expand the ability of European banks, especially small and medium ones, to access ECB liquidity[2]. The focus was on avoiding a tail risk event by providing abundant liquidity to banks and softening the collateral rules to support the demand for long-term liquidity. In the first ECB auction of three-year liquidity, demand was strong as European banks bid for €489bn[3]. The December three-year LTRO was a success in avoiding a credit crunch (i.e., a tail risk event) even if de-leveraging pressures remain. ECB's measures are probably more about limiting de-leveraging rather than reversing it, but that is enough to avoid the worst case scenario. It seems that the ECB provided a sufficient backstop to bank funding to allow term debt markets to re-open, even if interest rates paid are still very expensive for the banks. Strong demand is anticipated at the second LTRO on 29 February. At February's meeting, Mr. Draghi pushed for a strong take-up of the 3Y LTRO on 29 February, as he emphasized that there is no stigma associated with using these facilities. Also, he was careful not to rule out the possibility that the ECB could participate in the Greek debt restructuring by saying that the sale of Greek government bonds to the EFSF without a loss is not monetary financing. This could well be the case at the average purchasing price of about 75% of ECB's holdings i.e., Greece would need to repay 25% less at the time of maturity. Another sign of the success up to now of the three-year LTROs has been the substantial declines in peripheral yields even as ECB's policy on its bond-purchasing programme (SMP) has remained unaltered.

Wait-and-see approach on both policy rates and non-standard measures in the near-term

On monetary policy, our baseline expectation continues to be an additional 25bp rate cut within Q2. However, in the near-term the ECB will most likely be on a wait-and-see mode. Hence, a rate cut on 8 March is now unlikely but the odds that it would take place further ahead –in he second quarter– still remain. On non-standard liquidity measures, we think that the ECB will also opt to wait for the outcome of the second three-year LTRO and its impact on funding markets. In short, the ECB will prefer to remain cautiously alert in the near-term as it assesses the effects of recent policy moves.

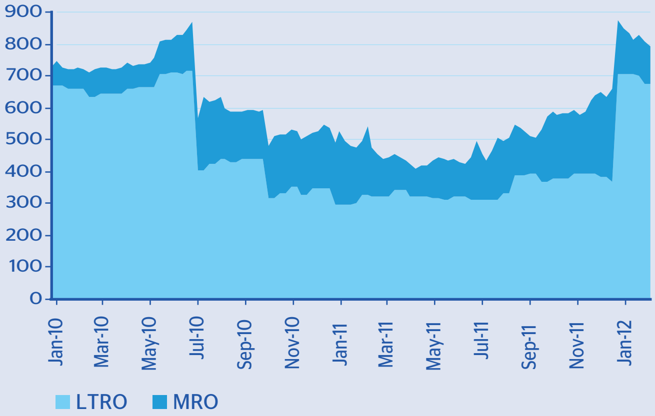
1: With the option of an early repayment after one year i.e., banks can pay the money back any time after the first 12 months if they want
2: The ECB will allow National Central Banks to accept temporarily as collateral for Eurosystem credit operations additional performing credit claims that satisfy specific eligibility criteria i.e., the ECB is relaxing the rules on what counts as valid collateral to include a broader set of credit claims. In addition the ECB decided to reduce the reserve ratio from 2% to 1% from the January reserve period, which started on 18 January. This measure increased the available collateral to banks.
3: €296bn of this converted pre-existing ECB funding; the remaining €193bn was therefore the extra funding that banks requested.

Chart 4
EMU: summary of liquidity conditions



Source: Bloomberg and BBVA Research

Chart 5
ECB: lending to EMU credit institutions (€bn)



Source: Bloomberg and BBVA Research

Box 3. Experiences of large fiscal consolidations in developed economies

Many European peripheral countries (including Spain and Italy) are currently implementing ambitious fiscal consolidation programmes for 2012. In line with the objectives set by the European Commission, Spain will have to reduce its public deficit by around 3.8 percentage points of GDP in 2012, and Italy will have to do so by 1.6 pp. Other countries will cut their deficits: Portugal[4] (3.5 pp), Greece (1.2 pp) and Ireland (0.9 pp). Clearly, these are fairly ambitious targets for many of these countries, which prompt us to compare the present situation with past experiences of fiscal consolidation.

Not all past experiences of deficit reduction are comparable with the programmes that will be implemented in Europe in 2012, as fiscal consolidation can be carried out for reasons other than to reduce the deficit. For instance, deficits may be reduced because of an improvement in the economic cycle, or due to a sharp increase in asset prices (e.g. a housing bubble). Alternatively, restrictive fiscal policies may be implemented to prevent an economy from overheating, in which case, the reduction of the deficit is a consequence of these measures, rather than a specific target set by the economic authorities.

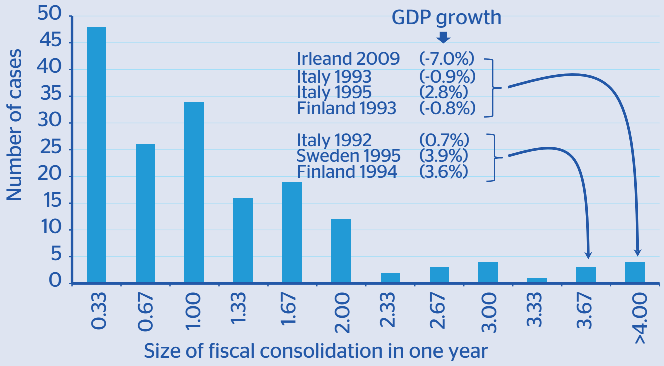
With this in mind, taking as relevant sample a group of 17 OECD member countries[5] for a period between 1978 and 2009, a total of 173 episodes can be observed (country and year) in which the authorities implemented measures aimed specifically at reducing the fiscal deficit.[6] These episodes point to three important conclusions.

Firstly, (Chart 6), consolidations of more than 4% of GDP in one year have only been seen on three occasions: in Ireland in 2009 (4.7% of GDP) and in Italy in 1993 and 1995 (4.5% and 4.2%, respectively). There are five cases of consolidations of more than 3 percentage points of GDP: Finland in 1993 and 1994 (3.7% and 3.5% respectively), Italy in 1992 (3.5%), Sweden in 1995 (3.5%) and the Netherlands in 1983 (3.2%).

Second, even though a deliberate policy to reduce the deficit was in place, in all likelihood, the positive economic environment evident in most cases helped countries meet the targets established by the authorities. Looking at growth rates seen in this period, it is clear that most of the economies grew at an above-average rate compared to previous years, and only three of the eight countries quoted experienced recession. This bears an important relation to the situation currently affecting many European economies, which will not be helped by a growing economy or a positive international environment.

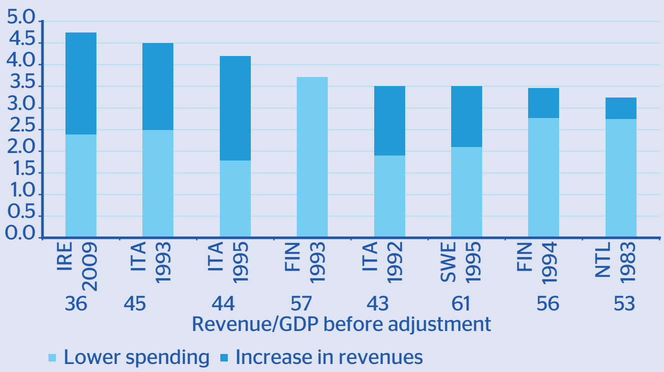
Lastly, a look at how the programmes were carried out tells us that in the eight cases analyzed, 65% of the adjustment was achieved via spending cuts. Specifically, cutting public spending helped reduce the deficit by no more than 2.5 pp of GDP, while the rest was achieved by increasing revenues, except when the tax burden was already high, as in Nordic countries (Chart 7), which would have made it difficult to levy further tax increases to meet consolidation targets.

Chart 6
Size distribution of annual fiscal consolidations in OECD countries aimed at reducing the deficit



Based on 173 cases of action-based fiscal consolidation in 1978-2009 for 17 OECD countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Portugal, Spain, Sweden, UK and US)
Source: BBVA Research based on Devries et al (2011)

Chart 7
Biggest annual fiscal consolidations in OECD, (% of GDP) 1978-2009: decomposition by type of adjustment



Source BBVA Research based on Devries et al (2011)

4: It does not include private banks' pension funds transfered to the State during 2011
5: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Holland, Portugal, Spain, Sweden, the UK and the USA.
6: "A new action-based dataset of fiscal consolidation", Devries, Guajardo, Leigh, Pescatori, IMF, June 2011.

3. Recent trends and projections

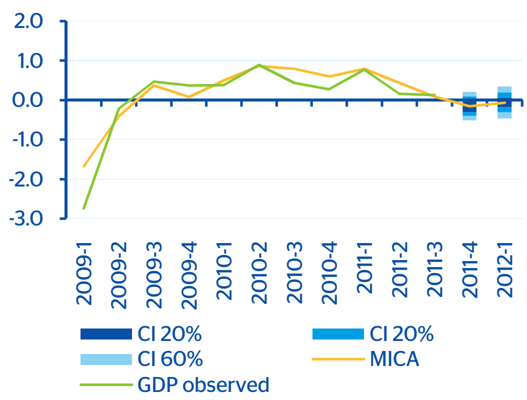
3.1 Eurozone

The eurozone recovery ran out of steam in Q3, while drivers worsened further during Q4, with short-term indicators suggesting a mild contraction

Eurozone GDP growth slowed again in Q3, only supported by the still robust global demand, while domestic expenditure failed to take off despite the rebound of private consumption. Investment dropped again for the second quarter in a row, while ongoing fiscal consolidation resulted in dropping public consumption. Data available for Q4 shows a deterioration of the economic situation in the eurozone, associated with developments that had been previously considered as downside risks to our scenario incorporated in the Europe Economic Outlook of November 2011. They include mainly a substantially worsening in the development in financial markets, including sovereign debt concerns and banking sector issues, and a weaker global recovery than previously expected.

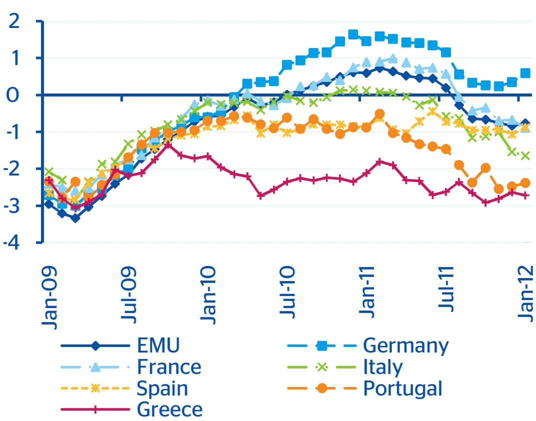
In particular, the increased uncertainty around the sovereign debt crisis and its linkage with the banking system adversely affected confidence of both households and firms, which collapsed during Q4. Retail sales declined more than expected in November (-0.7% q/q over Q3) and thus, combined with the continuous deterioration of consumers' confidence and the increasing unemployment rate, suggest that the support of households' spending to demand could be fading in Q4, in contrast with Q3. Industrial production already contracted in Q4, reflecting the fall in both domestic and foreign demand. Lower economic outlook prospects combined with idle capacity utilization and higher financing costs have probably triggered a significant fall in investment in Q4. In addition to this drop in private demand, strong fiscal adjustments proceed in many countries, mainly in the periphery, undermining public consumption. As a result, domestic demand might have subtracted growth for the third quarter in a row, thus increasing concerns about the fragility of the economic situation, which was still supported primarily by the external sector. In particular, despite the slowdown in global demand and, hence, exports, further deceleration in imports has continued to support the positive contribution of net exports to economic growth.

Chart 8
Eurozone: MICA-BBVA and GDP observed (% q/q)



Source: Eurostat and BBVA Research

Chart 9
Confidence by country (standardized)



Source: European Commission and BBVA Research

Overall, our short-term model (Chart 8) for quarterly GDP projects that eurozone activity should have contracted in Q4 (-0.2% q/q), although our scenario envisages a slight deeper fall (-0.3% q/q). Overall, GDP would have grown by 1.5% in 2011, slightly less than in 2010, mainly due to the lower support of domestic demand (0.6pp instead of 0.9pp), while the contribution of net exports remained relatively stable (around 0.9pp).

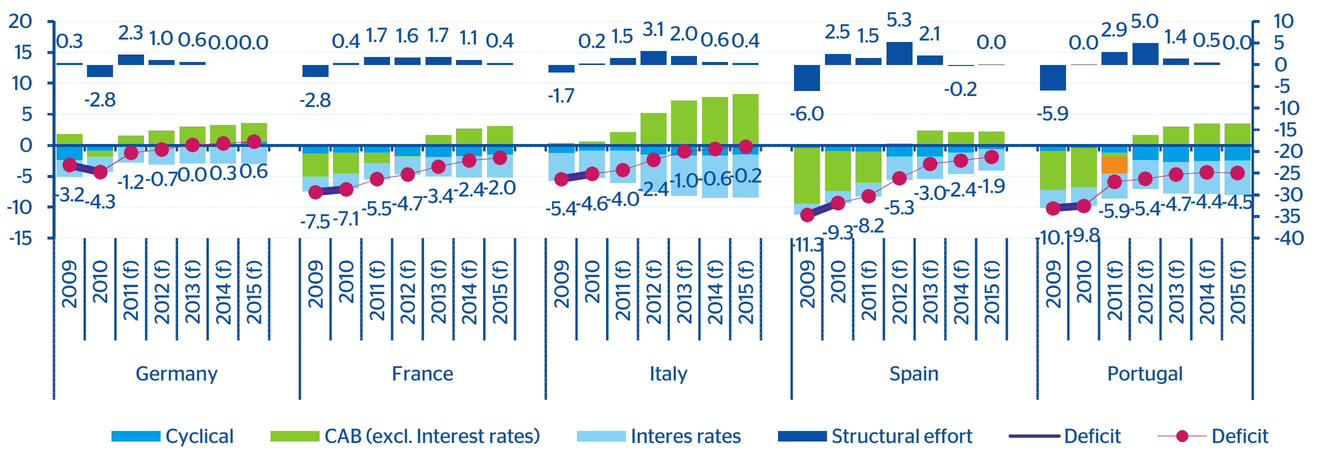
Across countries, we expect GDP to have contracted in Q4 in both core and peripheral areas, although growth differences persist (Chart 9), due to differing paces of fiscal adjustment (Chart 10) and to idiosyncratic imbalances cumulated in each country. In particular, the unemployment rate in the eurozone has increased by around 0.5pp since April to 10.4% in December, after the stabilization observed over the previous year and a half, with the strong differences across member states.

More positive signs, though preliminary, observed at the beginning of 2012

This widespread economic decline at the end of 2011 along with the worsening financial situation and the closing funding markets in the monetary union led the ECB to relax monetary policy again in November and December, also supported by expectations of moderating inflation. Along with these measures, the ECB reinforced its provision of liquidity to the banking sector with 3-years auctions in order to reduce the risks of a sharp contraction of credit and indirectly support sovereign bonds (see Box 2).

Some positive but still limited news arrived at the beginning of the year, as the confidence improvement in January confirmed the interruption of the sharp decline observed over H2 2011 and suggested that the through might be behind us. Nonetheless, significant differences remain across member states, as better outturns largely reflected better data in Germany and very modest growth in France, while the rest of the region continued to undergo a steep downturn (Chart 9). In particular, our MICA-BBVA model suggests the recession in the eurozone as a whole is likely to be only mild in the current quarter and more moderate than the one we expect for Q4. Still, these positive signs should be confirmed in coming months, as uncertainty remains very high while the results from the EU summits are not enough to definitively solve the European crisis.

Chart 10
General government debt and estimated structural adjustment



Source: Eurostat and BBVA Research

Feeble growth is projected for the second half of 2012, progressively accelerating in 2013

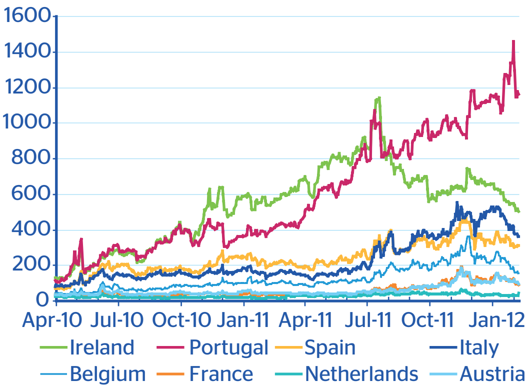
Unlike what we expected three months ago, measures agreed at the European level in December were not sufficient to mitigate the current crisis, increasing financial strains (Chart 11) to levels even slightly higher than those observed in the second half of 2008, leading to a very strong drop in confidence and a sharp increase in financing costs of sovereign debt. This is being accompanied by fiscal consolidation plans to ensure the sustainability of public finances. In addition to sharp adjustments submitted by countries rescued by the EU and the IMF (Greece, Portugal and Ireland), other countries, especially Spain and Italy, but also France, have approved strong fiscal measures in order to meet their fiscal targets agreed with the EU for 2012 and 2013 (Chart 10). This will have a negative impact on economic growth in the short-term, which could lead to further fiscal slippage that could trigger further fiscal adjustments. Additionally, the price and quantity restrictions on public funding have been channeled to the private sector (Chart 12), which is likely to have a strong effect on activity given the reliance of eurozone economies of credit financing.

In contrast, the positive drivers that could sustain economic growth continue to be few and weak. First, the relaxation of monetary policy, more accommodating to economic weakness, and above all, providing strong liquidity aiming at restoring the normal functioning of financial markets and the return of credit to both households and firms. Second, the recent depreciation of the euro, which could also give support to exports, partly offsetting the slowdown in global demand.

With such economic drivers, and assuming that financial strains will progressively diminish over the second half of the year, our economic scenario implies a significant downward revision on the economic outlook for 2012, from a moderate economic recovery to a mild contraction in activity for the whole year. This is due to a slight fall in activity over the first half of the year, returning to timid quarterly growth rates in the second half. In particular, GDP growth has been revised down by 1.5pp to -0.5%. This strong review is determined firstly by the carryover effect of the quarterly GDP fall anticipated in Q4 11 (which explains -0.3pp of the revision), as well as additional fiscal adjustments (-0.4pp) and the tightening of financial constraints (-0.8pp). The effect of the global economic slowdown (-0.1pp) should be offset by the depreciation of the euro (+0.1pp). As a result of declining activity, the labour market will continue to deteriorate, with lower employment (-0.2%) and an increasing unemployment rate (by 0.5pp to 10.6%).

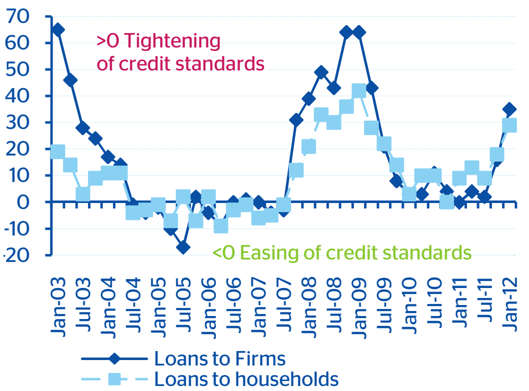
The recession will be felt mostly in the evolution of the components of domestic demand. Private consumption should fall slightly, driven by the sharp drop in consumers' confidence and declining real disposable income, only supported by the moderation in inflation. Large differences are expected in the performance of this component across countries, as a result of the differing degree of imbalances to be addressed, in terms of unemployment, fiscal deficit or private debt. This decline in domestic spending along with slowing global demand and still idle capacity utilization will also dent investment, for which we project a significant fall in 2012. Given the wide divergence in the degree of openness across countries, investment will remain more resilient in those with comparative advantages in exports to emerging economies. Unlike other economic downturns, the lack of expansionary fiscal maneuver will end up resulting in a fall in public consumption and investment. Therefore, the only source supporting growth will continue to come from exports, although they will slow significantly and will not be a strong dynamizing factor for other sectors. However, given the sharp slowdown projected for imports, we expect a positive net exports contribution (+0.2pp), which will partly offset the drop in domestic demand (-0.7pp).

Chart 11
10y sovereign spreads (bps)



Source: Bloomberg and BBVA Research

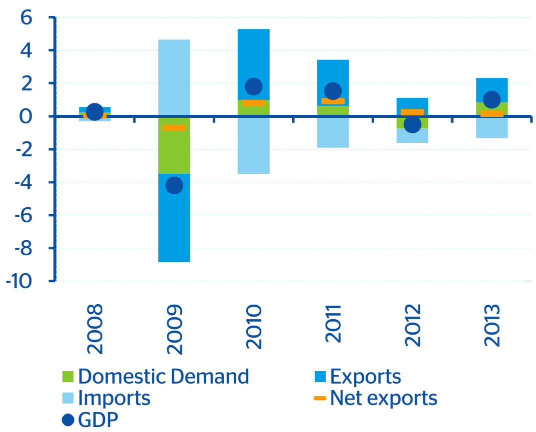
Chart 12
Eurozone: credit standards, past three months (Weighted net percentage)



Source: ECB

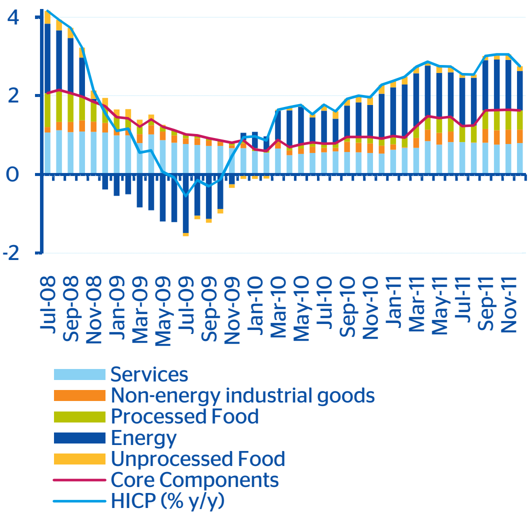
For 2013, the gradual recovery over H2 12 is expected to consolidate, with GDP registering moderate growth, of around 1%, but still below its potential level. In this scenario we assume that the sovereign debt crisis will be tackled along the current year, with a strong firewall to prevent adverse spillovers form spreading to other member states. Therefore, all components of domestic demand should return to moderate growth rates, resulting in considerable contribution of domestic demand and thus a more balanced growth pattern between the domestic and foreign sectors (Chart 13).

Chart 13
Eurozone: Contribution to annual GDP growth (pp)



Source: Eurostat and BBVA Research

Chart 14
Eurozone: Annual HICP inflation rate. Contribution by components (pp)



Source: Eurostat and BBVA Research

Risks to this economic outlook remain tilted to the downside

The main risk to the current scenario is related to a disorderly restructuring of Greek debt at some point during 2012, either because an agreement is not reached in the tripartite negotiations between Greece, the troika and private investors or because Greece does not fulfill the requirements of reform and the troika decides to stop the support. This risk has probably diminished, though. Another downside risk is the possibility that stress continues and currently high levels persist for the rest of 2012 and beyond. Finally, fiscal consolidation could have a larger impact than expected in those countries facing sizeable fiscal adjustments in 2012 and 2013, which could derive in some sort of deficit –recession spiral if fiscal targets are pursued too rapidly. On the positive side, it could be the case that the very recent stabilization and even (in some countries) improvement of PMI data reveal an underlying starting point which is stronger than expected.

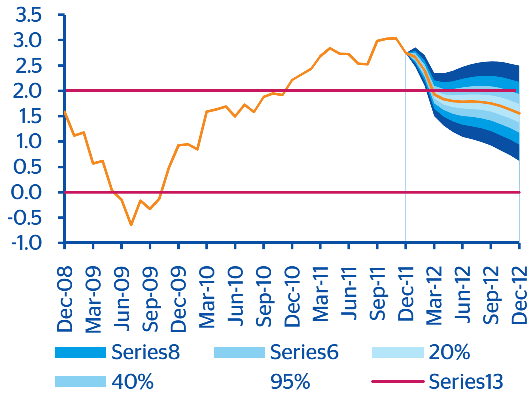
Inflation should revert below the ECB target over 2012, allowing the ECB to take a more proactive role

Inflation data for Q4 2011 confirmed that the sharp acceleration observed late in Q3 was mainly due to soaring prices of seasonal products (non-energy industrial goods and food), showing that inflationary pressures continued to fade due to the deterioration of both economic activity and the labour market. However, our inflation outlook three months ago envisaged a moderation in headline inflation in Q4 11, but this was only observed in December, mainly reflecting a lower slowdown of oil prices (Chart 14) than anticipated at that time. By contrast, core inflation remained broadly stable at 2% in Q4, as expected. As a result, headline inflation ended 2011 recording an annual average rate of 2.7%, 0.1pp above our central forecast, while core inflation averaged 1.7%.

Across member states, significant differences in the annual harmonized inflation remained, with higher rates registered in the periphery. This responds primarily to tax hikes or increasing administered prices tied to fiscal consolidation (see Greece, Portugal and Italy in Chart 16) that compensated for disinflationary pressures from depressed domestic demand and could undermine further households' demand through the negative impact on real disposable income. Excluding tax effects (Chart 16), inflation rates by countries should be more in line with the average inflation for the eurozone, and also reveal lower price pressures in countries where private consumption has been plummeting, as in Greece.

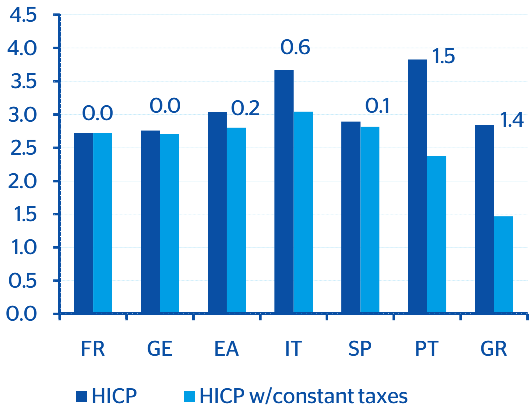
Looking ahead, we continue to see a moderation (Chart 15) in headline inflation in coming months as a result of favorable base effect in energy prices following the sharp rise observed especially in Q1 11. However, we now expect this moderation to proceed in a somewhat lower pace than anticipated three months ago, with headline inflation falling below the ECB's target in Q2 12. After that, headline inflation might remain relatively stable in the second and third quarter, to ease further at end of the year, resulting in an annual average inflation rate of 1.8%. Regarding core inflation, it is set to slow slightly throughout this year as a result of weak domestic demand, leaving the annual average for 2012 at 1.7%.

Chart 15
Eurozone: HICP (% y/y)



Source: Eurostat and BBVA Research

Chart 16
HICP by country in November 2011 (% y/y, values are differences in pp between rates)



Source: Eurostat and BBVA Research

Risks to this inflation outlook are broadly balanced, but higher oil prices combined with potential tax hikes could curb the pace of slowdown in the short-run

Upside risks continue stemming from geopolitical tensions in the Middle East that could result in higher oil prices, but also from a lower slowdown in emerging economies in their move to stronger demand for raw materials. This also binds to a further depreciation of the euro that could end up in higher prices of energy imports. Additionally, higher taxes or administered prices associated with major fiscal adjustments may not be ruled out. Nevertheless, these upside risks should be compensated for the worsening of the underlying drivers of households' spending, while the deteriorating labor market might contain wages and poor business expectations about future demand could curb potential higher costs coming from commodities.

Box 4. United Kingdom: Growth halt expected to be short-lived as further stimulus is in the pipeline

Economic activity in the United Kingdom remains affected by the strains of the eurozone crisis and under its own fiscal consolidation, whose impact on growth is sizeable. As a reaction, in February the Bank of England increased its asset purchase programme by 50 bn GBP, as the recovery is weaker than expected and price pressures are fading.

Economic activity fell in Q4....

The British economy contracted in Q4 by -0,2% q/q (Chart 17), leading to an overall increase of just 0.9% in 2011 over 2010. The contraction was in line with hard indicators such as the industrial production index, although it is somewhat at odds with PMI data (Chart 18), which have been improving in Q4 and early Q1, suggesting that the recession is going to be mild. Household confidence according to Gfk index also recovered substantially.

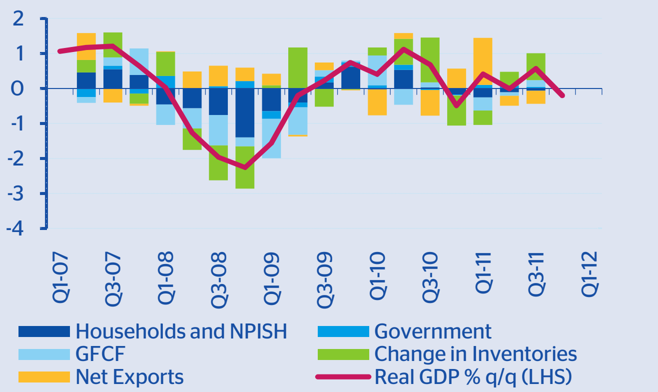
... and is expected to pick-up during the year but at a slow pace

In view of the weaker - than - expected momentum at the end of 2011, the ongoing uncertainty surrounding the external environment, mostly in the eurozone, and the higher than expected impact that fiscal restraint seems to be exerting on private consumption, we have revised slightly downwards our projections for this year. We now expect growth to be at 0.5% in 2012 and 1.4% in 2013 (-0.2 pp lower than expected in both years three months ago). On a positive note, the Olympic Games hosted in London this summer will lead to a temporary pick up in demand.

Private consumption recovery in between two counteracting forces: higher unemployment and higher real income

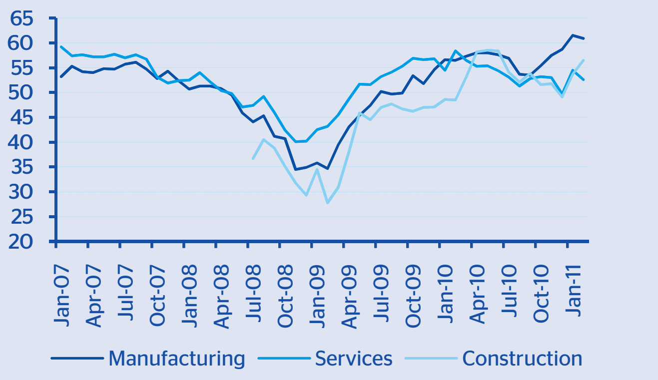
The outlook on private consumption is highly uncertain as the labour market continues to deteriorate but inflation is moderating, halting the squeeze of real incomes. The unemployment rate continues to increase, having posted new record highs by the end of 2011 (8.4%, in November according to ILO statistics), while prospects for 2012 remain negative. Monetary aggregates continued to decline in December, hinting to weakening activity and the continuation of the deleveraging process. In contrast, the fall in inflation this year, after the sharp increase registered in 2011, will sustain real disposable income. This, together with the signs of recovery in household confidence, makes us project a moderate recovery of private consumption of 0.3% in 2012 (after falling by around -0.5% last year) (Chart 19).

Chart 17
UK: contribution to GDP % q/q growth



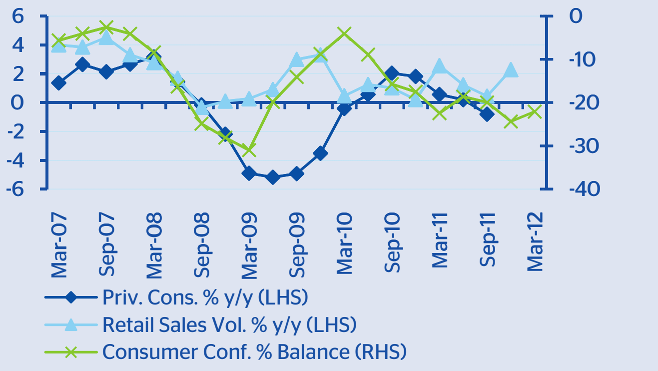
Source: ONS

Chart 18
UK: Purchasing Manager Index (PMI)



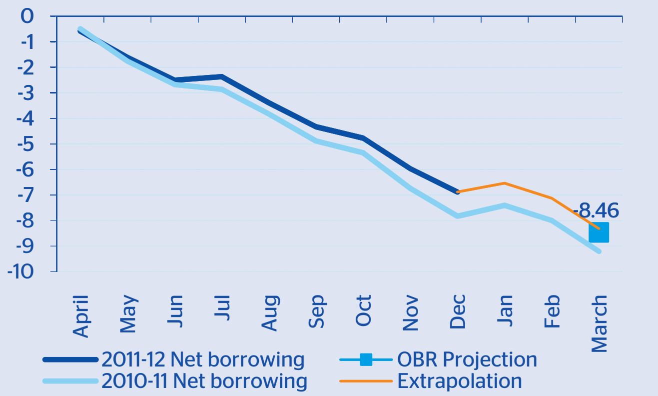
Source: Markit

Chart 19
UK: private consumption, retail sales and consumer conf.



Source: ONS and BBVA Research

Chart 20
UK: public sector net borrowing as % of GDP



Source: ONS and BBVA Research

Investment moderated the pace of growth in 2011 after the increase in 2010 related to the increase in VAT, that brought forward investment. It should remain subdued this year, in particular at the business level. Investment in dwellings will be also contained given the poor outlook of the labor market. Public consumption continues to show some resilience and has been increasing moderately, but it is expected to slowdown further in coming quarters and years in line with fiscal adjustment plans to bring the budget back to balance by 2015-16. Budget execution data for the current fiscal year up to December shows little improvement with respect to previous years, and given the fall in activity in Q4 and weak prospects for the first quarter, risks of minor slippages are high. In December, the budget excluding financial interventions stands at -103 bn GBP, while for the whole fiscal year ending in March the target is set at -127 bn GBP (-8.4% of GDP) (Chart 20).

Regarding the external sector, both exports and imports fell in Q2 and Q3, reflecting the weakness of its main trading partners and its own domestic activity. The high dependency on industrial countries as main trading partners will weigh on export activity in coming quarters, and we expect an exports slowdown from an estimated 4.7% increase in 2011 to 2.2% this year. Imports are expected to perform somewhat better on average this year. As a whole, the contribution to growth from the external sector will be about flat.

Inflation is moderating its pace, at last

After months of a clear deviation from targets and concerns regarding the temporariness of these deviations, the rate of inflation seems to be in the process of reversion. Last year the VAT increase by 1 pp and high energy prices boosted inflation rates, reaching its maximum at 5.2% in September. Liquidity injections through the QE programme should have also had an effect. For 2012, we expect inflation to revert rapidly and average 2.5%. Three factors will be at play: 1) the base effects, 2) lower prices in energy due to cuts in energy prices from major energy firms and 3) the impact of spare capacity. However, the devaluation of the British pound and the observed willingness to pass-through the increase in prices to final consumers may lead to a slow pace of reversion.

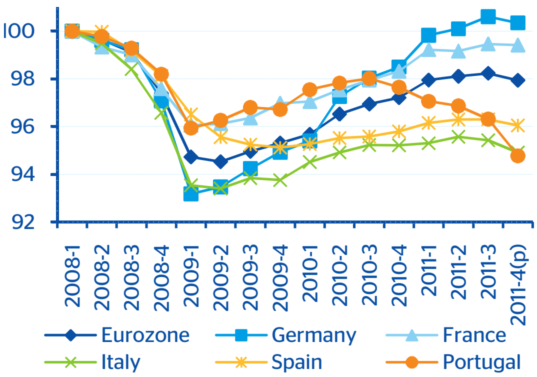
Further Quantitative Easing in the pipeline

In February, the latest tranche of purchase programme was completed, and an additional increase by 2,50 bn GBP has been approved in the light of the weak state of the economy within the expected range of 50-75 bn GBP. Interest rates remained stable at 0.5% along 2012, and we expect them to remain so for the forecast horizon.

3.2 Member States: a closer view

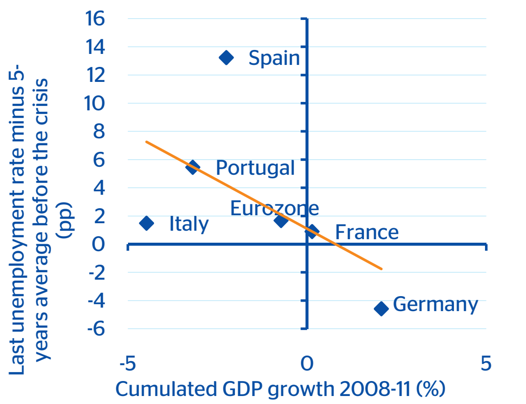
The strong drop in confidence was widespread over Q4 and affected all member states and was reflected in an estimated GDP contraction in both core and peripheral areas at the end of 2011. Still, differences persist (Chart 22), due to differing paces of fiscal adjustment that will weigh markedly on domestic demand (Chart 24), while exports might remain the main driver of growth for all member states (Chart 25). In addition, labour market conditions are set to worsen somewhat in the forecast horizon, but also with strong differences across countries as observed in previous years (Chart 23). This evolution at different paces throughout the eurozone (Chart 26) will cause real GDP in 2013 to be well below pre-crisis level in the periphery, while in German and France it will exceed those levels by about 2%. For the eurozone as a whole it will be at the same level (Chart 27).

Chart 21
GDP by country (Index, 1Q 2008=100)



Source: Eurostat and BBVA Research

Chart 22
Cumulated unemployment rate and economic growth



Source: Eurostat and BBVA Research

Germany: not immune to the eurozone crisis, but more resilient

Germany managed to expand considerably in 2011, by 3.0%, surpassing all other eurozone countries. Strong exports, benefiting from robust global demand from emerging economies, also supported other sectors, especially investment, reflected in GDP growth that was mainly driven by domestic demand, which contributed +2.1pp. Net exports are expected to contribute 0.9pp to GDP growth, despite the strong imports resulting from robust domestic demand.

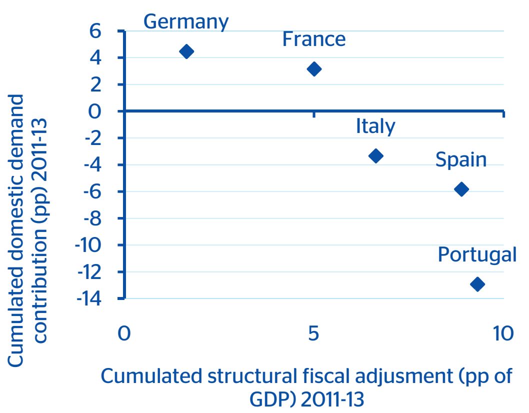
Nonetheless, this robust economy growth hides German vulnerabilities to increasing uncertainty and materialization of some downside risks in the eurozone, as data available for Q4 are pointing to a mild contraction in Q4 11, likely to extend in Q1 12, although January soft data were better than expected. In particular, retail sales have declined on average in Q4, while consumer confidence, as measured by the EC indicator, stabilized in Q4 at subdued levels after falling sharply in Q3, indicating that private consumption has been losing ground at the end of the year. The prospects for investment are also gloomy, with industrial production exhibiting mild negative growth on average and new orders even more negative in both Q3 and Q4 to November. Soft indicators point in the same direction, with PMI manufacturing rebounding only in January, after remaining in contractionary territory since Q3. At the same time, the services sector followed a similar path, as PMIs showed deterioration in Q3, only slightly corrected in Q4. External trade data up to November showed a significant slowdown in both exports and imports, but suggested that net export contribution should have been easing at the end of the year.

Although the German economy proved to be more resilient than that of other member states, the slowdown of global demand and high uncertainty in the eurozone could be felt negatively in the economic outlook. We now expect GDP growth in 2012 to slow down more than anticipated three months ago, to expand mildly at 0.5%. Exports growth is projected to moderate in coming quarters, while imports growth might remain stronger, leading to a significant fall of net exports contribution for 2012 (0.0pp after 0.9pp in 2011). Despite the fact that high uncertainty could have negatively affected domestic confidence and demand, this effect should be limited by the robustness of domestic fundamentals. Prevailing uncertainty might force firms to postpone some of their projects, on top of moderating exports. As a result, investment is expected to slowdown sharply, and thus one of the key drivers of the upturn could fade. The current deterioration of consumers' confidence could negatively affect private consumption, although labour market resilience should continue to support households' disposable income, due to robust growth and lower inflation. In addition, this outlook for resilient households' spending is further supported by the absence of high households' indebtedness, as well as a relatively limited fiscal adjustment. Overall, domestic demand will continue to drive growth this year, contributing with 0.6pp to growth. We expect this pattern of growth, driven by domestic demand, to continue over 2013, returning to its potential growth. As a result, the high current account surplus might wane over the forecast horizon.

On the fiscal side, the deficit target for 2011 will be achieved with ease due to the good performance in economy activity this year and therefore better than expected tax collection. The overall balance is expected to close with a -1.2% of GDP deficit compared to the target set at -2.5%. This implies a preliminary estimate of the structural adjustment at around 2.3 pp of GDP. Looking ahead, the goal for 2012 is already met as long as the economic slowdown does not impact very negatively. Debt level is hovering at around 80%, although it may be revised downwards for 2011 given lower than expected valuation of the rescue of Hypo Real Estate and West LB banks.

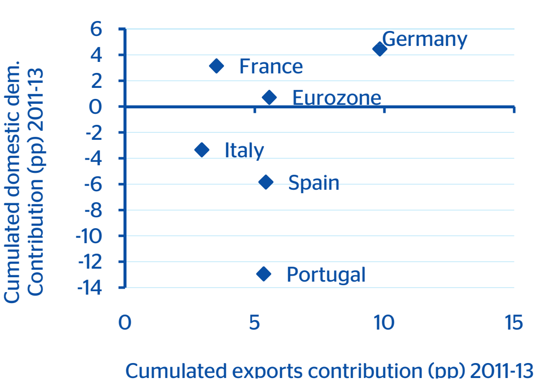
On prices, harmonized inflation moderated sharply at the end of last year, driven by positive base effects in energy prices, following the sharp increase observed in late 2010 and earlier 2011. In contrast, core inflation has remained relatively stable since Q2 2011, hovering around 1.6% y/y, dispelling doubts about inflationary pressures resulting from robust domestic demand. The moderation trend in headline inflation is expected to continue in coming months to remain below the ECB target, averaging at 1.8% in 2012.

Chart 23
Structural fiscal adjustment and contribution of domestic demand to GDP growth



Source: Eurostat and BBVA Research

Chart 24
Cumulated domestic demand and exports contribution



Source: Eurostat and BBVA Research

France: worsening confidence takes its toll on domestic demand, leaving the main driver of growth out of play

Economic activity improved in Q3 (0.3%q/q), after a fall back in Q2. GDP growth has been driven by domestic demand, both consumption and investment. In this sense, the pattern of growth is similar to the one that allowed France to withstand the previous downturn much better than other countries of the eurozone, which were more vulnerable to the external shock. However, the deterioration of activity at the end of 2011 has been mainly the result of an idiosyncratic shock in the eurozone that has affected domestic demand through a confidence effect. Economic indicators already point to sharp deterioration in Q4, with soft data suggesting a breakdown of confidence at all levels in Q3 that has been maintained in Q4.

Worsening labour market conditions add further to the already disappointing picture. Unemployment increased by 0.3pp during Q3 to reach almost 10%, and is seen as the principal factor driving the observed fall in consumer confidence. On the positive side, the private sector shows some signs of a rebound, led by services. Though industrial production recovered somewhat during the last month, on average it has been losing ground (-0.3% on a three-month moving average to November). Exports slowed up to November, though the fall in imports was substantially deeper, suggesting that net exports might not have been a drag at the end of 2011.

Worsening confidence along with an additional fiscal adjustment announced over the last three months have led to a downward revision in our GDP growth forecast for 2012, by around 0.8pp to 0.2%. After the significant rebound in 2011 (1.9pp), domestic demand is expected to contribute only with +0.1pp in 2012, owing to the noticeable slowdown of all its components, although with more resilient households consumption. Public consumption is going to lose ground amid fiscal consolidation measures, while investment is also expected to step back, as financing conditions are squeezed and utilization rates together with demand follow a deteriorating path. The inventory cycle support might have come to an end, after the very strong contribution in 2011 (around 1pp in 2011). On the external side, after the negative contribution in 2011, the situation is expected to improve somewhat this year, but mostly due to the slowdown of imports. This will result in a slight positive net exports contribution to growth (+0.1pp).

In the short-term, fiscal adjustments are shaping economic growth. The 2011 target at -5.7% is expected to have been met, implying a structural adjustment of around 1.5pp. According to our estimates in order for the government to meet the fiscal target for 2012 (established at -4.5%), measures should amount 2 pp of GDP. The latest package announced last November implies a modest adjustment of 0.3% of GDP additional to the 0.5% announced in August. The latest measures include the removal of the indexation on revenue taxes, the introduction of a solidarity tax, the withdrawal of tax allowances and the introduction of an intermediate VAT at 7%. . With presidential elections due in May, we expect definitive details in coming months, although it is doubtful that they will arrive in time to meet the target for the whole year.

Inflation remained relatively stable and below the eurozone average until the end of Q3, accelerating somewhat afterwards to 2.7% in December, as in the monetary union. Although we expected a lower base effect due to energy prices than in other member states, increases in some excise duties and a new VAT rate may be behind the increase of inflation in the last quarter of 2011. In addition, various measures associated with fiscal consolidation (increase of excise taxes on tobacco and alcohol, etc.) will offset partly the disinflationary effect of lower oil prices and the subdued domestic demand. Overall, HICP inflation is forecasted to stay below the eurozone average, at around 1.6%.

Italy: recession in H2 2011 is set to continue over 2012, only stagnating in 2013

The Italian economy is in recession, with GDP recording negative growth already in the second half of 2011, while incoming data continue to be negative at the beginning of 2012. Nevertheless, the country still managed to post a growth of +0.4% in 2011 as a whole, thanks to the strong contribution of net exports (+1.3%), which more than compensated for the negative contribution of domestic demand (-0.9%).

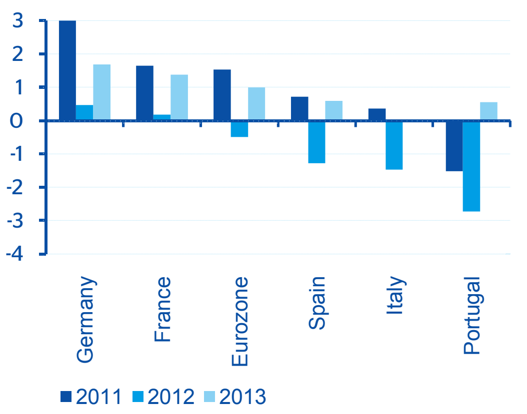
The economic drivers have worsened in the last three months. First, there is a clear, sharp increase in uncertainty, partly being a result of the rapid widening of spreads following the intensification of the eurozone sovereign crisis, but they have improved after Monti arrived. The latter triggers higher funding costs and more difficulties to access funds, resulting in tighter credit conditions. In addition, a strong and frontloaded consolidation adjustment over 2012-13 will also dampen domestic demand in the short-run. Finally, slowing global demand will also weigh on Italian exports, dampening the main driver of growth last year.

On the fiscal front, Italy roughly complied with its 2011 target set at -3.9% of GDP, implying a structural adjustment, of around 1.5 pp of GDP. But in 2012 the Italian economy will be required to double this effort. To do so, in addition to the adjustment packages announced after the summer in the midst of the financial turmoil, the government disclosed in early December the "Salva Italia" package that implies savings of €30bn, of which €10bn will be spent on pro-growth measures between 2012-14. The net adjustment amounts to €20bn (1.2% of GDP) supplementary the previously announced measures of €60bn. In principle, this should be enough to meet the balanced deficit target for 2013 . Among the measures included there are changes in the pension system to increase further the retirement age, working years for pension eligibility and the freeze in current pension payments. On the revenue side, some taxes will be raised, in particular the VAT (by 2 pp to 23% by September 2012 and an additional 0.5 pp by 2014) and real estate taxes on primary residences, while measures to fight tax evasion will be stepped up.

Taking into account these factors, we have revised significantly downwards our economic outlook for 2012 from a virtually flat economy to a significant fall in activity (-1.5%). The prospects of private consumption are worsening and after a moderation in performance during the previous year, compared to the strong results of 2010, households´ demand is seen collapsing in 2012. In particular, persistently weaker labour market conditions and inflationary pressures continued affecting negatively spending decisions in H2 11, while in the quarters to come the real disposable income effect is going to be dampened by further austerity measures decided for 2012. The support to investment provided by external demand also weakened in H2 11 (tighter credit conditions and subdued domestic demand to affect adversely firms' investment decisions). For 2012, investment is expected to fall significantly, as financing costs remain elevated, capacity utilization is set to stay at low levels and the balance-sheet adjustment is ongoing, while government investment spending is forecasted to decline further as part of the budgetary consolidation strategy. As the slump in domestic demand is much stronger than the deterioration in the global conditions, exports are expected to overcome imports, resulting in a positive contribution of net exports to GDP growth for this and next year.

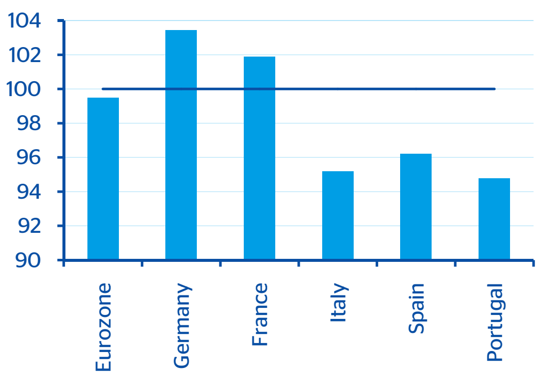
On prices, HICP inflation remained elevated throughout 2011, but the rise in VAT rate from 20% to 21% the previous September is expected to have a relatively moderate impact on headline inflation in 2012, partly offset by contracting domestic demand. With energy component forecast to decelerate due to declining oil prices and favourable base effects, headline inflation is expected to moderate over 2012, still not attaining the target set by the ECB.

Chart 25
GDP growth forecast by country (Annual average growth, %)



Source: Eurostat and BBVA Research

Chart 26
Real GDP growth in 2013 in percentage of precrisis level



Source: Eurostat and BBVA Research

Spain: recession in 2012; slow recovery in 2013

In addition to the ongoing correction of imbalances of the Spanish economy, a sharp fall in confidence, the slowdown in exports and economic policy uncertainty (linked to the change of government and the increasing probability of failure to meet fiscal targets) were compounded as negative growth drivers over Q4 11, resulting in a deterioration of activity (GDP fell by -0.3% q/q) and, especially, employment. The main positive driver of growth continued to be the contribution of net exports, while domestic demand fell strongly in the last quarter of 2011. As a result, GDP might have grown by around 0.7% in 2011 as a whole.

Higher uncertainty at European level has ended up affecting some of the fundamentals of the Spanish economy. On the one hand, access to finance is expected to remain tight owing to sovereign debt and banking crisis in Europe. In addition, the significant downward revision in growth prospects for the eurozone will result in a weaker demand for Spanish exports. Regarding domestic drivers, the main challenge is the slippage in the fiscal deficit target that ends up requiring an additional adjustment, whose size, composition and timing are not completely known but are key to estimate its impact on economic growth. The Spanish government had planned most of the reduction in the structural deficit (6.5% GDP in 2011) between 2009 and 2011 according to the approved Stability Plan by the European Commission. From 2012, the size of the adjustment might be lower, but new measures of around 2% of GDP this year were already priced in order to reduce the fiscal deficit. Nevertheless, missing fiscal targets in 2011 implies that the fiscal adjustment in 2012 should be around €40bn, although it could increase to €50bn to offset the cyclical decline in revenues and expenditures (see Spain Economic Outlook for more details). All these factors result in a significant downward revision for Spanish prospects in the forecast horizon.

Summing up, we expect GDP to contract in 2012 (-1.3%), recovering slowly in 2013 (0.6%). Given the worsening growth prospects for the Spanish economy, the labour market will continue to deteriorate further in 2012, leading to a rise in the unemployment rate (around 25%). This economic outlook could be positively affected if structural measures (such as budgetary stability and labour market reform) are carried out quickly and decisively, providing a less painful adjustment (especially in terms of employment) and setting the ground for a rapid and robust recovery.

On prices, annual inflation continued to slowdown, as expected, suggesting that high inflation rates in 2011 (3.2%) were resulting from the widespread base effect of higher prices of commodities in late 2010 and early 2011 combined with the VAT hike in H210. Looking forward, the weakness of domestic demand and the deterioration in the labour markets point to the absence of inflationary pressures, with both headline and core inflation remaining below 2.0% for the forecast horizon.

Box 5. Portugal in sharp recession in 2012 due to a large fiscal adjustment

Economic activity in Portugal contracted in 2011 -though somewhat less than anticipated- as stagnation in Q2 was followed by contraction in the second half of the year. The economy is set to remain in sharp recession in 2012, with a rebound foreseen as from 2013. The main driver behind this outlook can be found in the inevitable strong fiscal adjustment undertaken in 2012 and in the difficult market and financial conditions that have led most of the economic indicators into negative territory. Nonetheless, some support from the external sector still remains, despite very weak domestic demand.

The sovereign credit rating was recently cut to "junk status" by S&P, which resulted in a deterioration of Portugal sovereign debt, by increasing spreads of 10-year debt by around 300bp. As a consequence, there are justified fears that the first financing aid package provided by the Troika will not suffice as Portugal will not be able to return to markets as expected in 2013, and hence further support will be necessary, although the government has rejected such scenario. The second review by the Troika in November outlined the remaining challenges, mainly the need for a rapid implementation of the structural-fiscal measures and structural reforms in labour and product markets, but at the same time it noticed that targets have been broadly met and praised the efforts and progress the government has already made towards fiscal consolidation and return to growth.

Confidence continues fading at all levels, reflected in weakening industrial and service sectors, as well as in decreasing investment

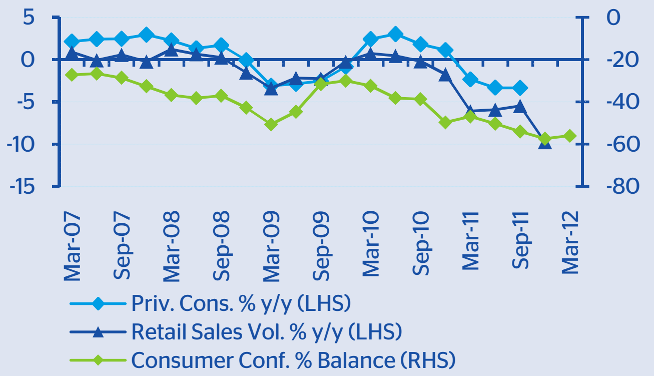
It has been more than a year since the economic sentiment started falling, and at the beginning of 2012 the trend continues, with the overall index losing 0.3p in January to stand at its lowest value of -4.7 (-1.3 points in Q4). Confidence deteriorated across the sectors surveyed, with manufacturing being the main sector driving the index down, while the situation in retail trade remained broadly stable. In contrast, the economic sentiment indicator (ESI) of the European Commission for Portugal gained 0.7p in December, bringing in some optimism.

There is not sufficient support for investment, which is expected to subside. Industrial production continued falling, losing -1.6% m/m in November, almost dropping by -3% on a 3-months moving-average basis. Activity in the industrial sector is expected to continue losing momentum, as suggested by industrial new orders, which fell for the third consecutive month in November (a 3-month average of -4.4%). The prospects for investment have been worsening sharply and in November all components made a negative contribution to growth, especially construction. Services are not improving either, with the change rate of the turnover index at -11.7% y/y in November. Employment, wages and hours worked, all decreased on the year.

Consumption has taken a downturn, with no rebound on the horizon, while the only source of optimism comes from the external sector

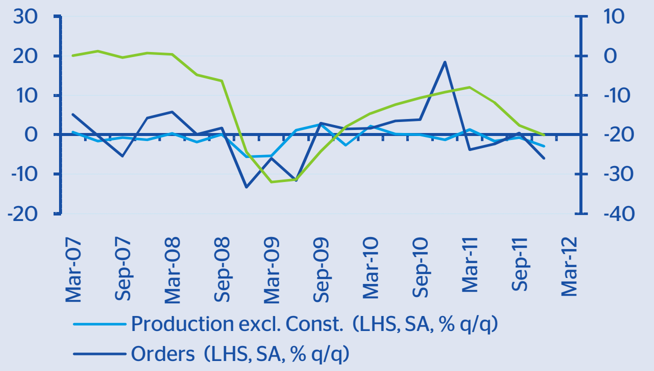
Already in Q3, consumption contributed negatively to year-on-year GDP growth by -5pp. In November, the private consumption indicator contracted sharply, due to weakening non-durable and durable consumption. In addition, retail sales figures saw continued deterioration, with the overall index losing -2.6% m/m and -2% on a three-month moving average in November. For 2011 as a whole, private consumption fell sharply, after a robust growth in 2010, and the situation will deteriorate further in the current year. This goes in line with the need to reduce the consumption to GDP ratio, which is very high as compared to other eurozone economies, and as we have argued in the past is one of the reasons behind the large current account deficit. The ongoing fiscal consolidation efforts (i.e. higher income taxes, lower transfers and price effects of increases in VAT and excise taxes) have not only restricted household disposable income, but have also brought government spending down.

Chart 27
Portugal: private consumption, retail sales and confidence



Source: EC, INE and BBVA Research

Chart 28
Portugal: industrial sector



Source: Eurostat and BBVA Research

Unemployment fears add to the gloomy outlook for household demand. Employment, number of hours worked and salaries were down on an annual basis. Unemployment is gradually increasing, but at a slow pace, reaching 13.2% in November and is expected to remain at high levels in the medium term.

On the positive side, the trade deficit is improving. Exports were stronger and imports weaker in the quarter up to November, compared to the same period of 2010 (+15.1%, -3.6% respectively). As a result, the trade deficit has narrowed by €2.04bn. The trade balance improvement adds on the positive contribution of net external demand for GDP growth in Q3 (+3.3pp). Throughout 2011, exports remained strong, while imports weakened, resulting in a very positive contribution to GDP growth (+4.0pp). The same path is expected to be followed in the current year, with a sharper fall in imports and some growth of exports, resulting again in a high contribution of net external demand to growth.

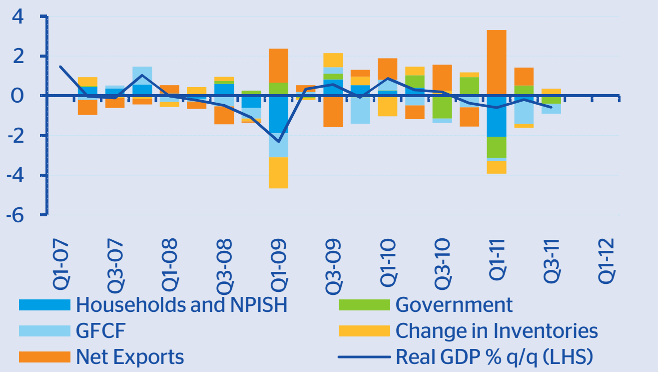
As a result, GDP is in sharp contraction. Our short-term model forecasts further recession in the quarters to come

Taking into account available data, our short-run MICA-BBVA model for Portugal (see Box 6) suggests that GDP could have contracted by around 1.6% q/q in Q4, resulting in an annual activity fall of around -1.5% in 2011. The Bank of Portugal monthly coincident indicator estimates a year-on-year fall of around -3.2% in Q4, somewhat more negative than our annual rate of -2.9% that is equivalent to the -1.6%q/q. Looking forward, activity is expected to contract further in coming quarters, responding to the strong fiscal adjustment foreseen and to the prevalence of adverse financial conditions, mitigated by the fact that probably the worst of the financial crisis should be behind us. Despite the high uncertainty surrounding sovereign debt crisis, we expect Portuguese GDP to fall by around 2.7% in 2012, somewhat lower than the official projection, with the negative contribution coming from domestic demand. The Bank of Portugal estimates a contraction of 3.1% in 2012, after an estimated 1.6% fall in activity last year; the new figure is broadly in line with IMF and government estimates.

Inflation in 2011 was on average well above that in 2010, due to energy price and VAT changes

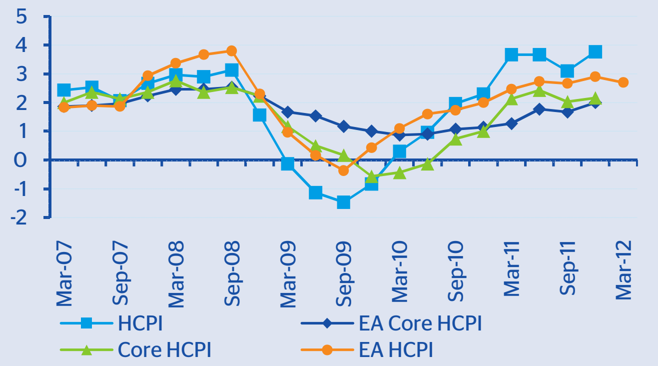
Both CPI and Harmonized–CPI averages in 2011 edged higher to 3.7% and 3.6% respectively, from 1.6% and 1.4% in 2010, and 0.9pp above the average rate in the eurozone. In December, annual inflation was also high, at 3.6%, reflecting mainly increases in the prices of energy and unprocessed food. Assuming their exclusion, the index would have been brought down to 2.3%. On the positive side, inflation is moderating on a monthly basis, with the rate at 0% m/m in December, and -0.1% m/m in November. Although the hike in indirect taxes will keep headline inflation elevated in the short term, in 2013 inflation will fall below 2%.

Chart 29
Portugal: contribution to GDP %q/q growth



Source: Eurostat and BBVA Research

Chart 30
Portugal: inflation %y/y



Source: Eurostat, INE and BBVA Research

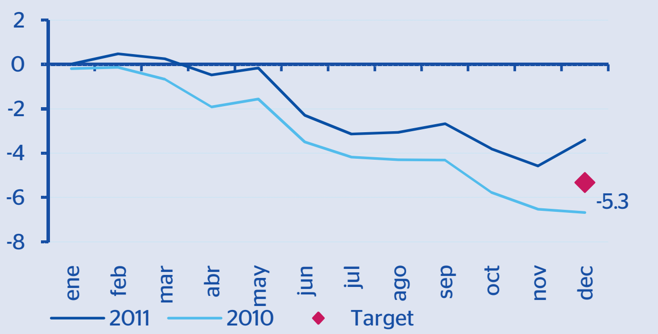
Budget for 2012 approved, heading for a significant deficit reduction explained by one-off measures

Portugal's parliament approved by end-November a severe austerity budget for 2012. The government has planned a large package of fiscal austerity for 2012, equivalent to 6% of GDP and concentrated mainly in expenditure measures. In addition, on the side of reforms, the focus has been recently on the labour market, where the government has designed broad measures to reduce severance payments to dismissed workers, increase incentives for work search for unemployed workers and increase the number of working hours in the private sector.

Portugal's budget deficit for 2011 was around 4.5% of GDP, considerably lower than the 5.9% target, mainly due to a 6bn transfer of bank pension fund assets and liabilities to the social security system. Without such transfers, the deficit was around 8% of GDP, which is the starting point for 2012 as the transfer (apart from generating a liability) is a one-off. On the borrowing side, state debt is trending up, reaching 104% of GDP in Q3 2011 (after 100% in Q2). Bad news came from the cut of the country's rating by S&P by two notches, to BB-plus from BBB-minus, placing Portugal in junk status, triggering an immediate exclusion of Portuguese debt from several bond-indices and raising its 10 year spread with Germany to over 13%.

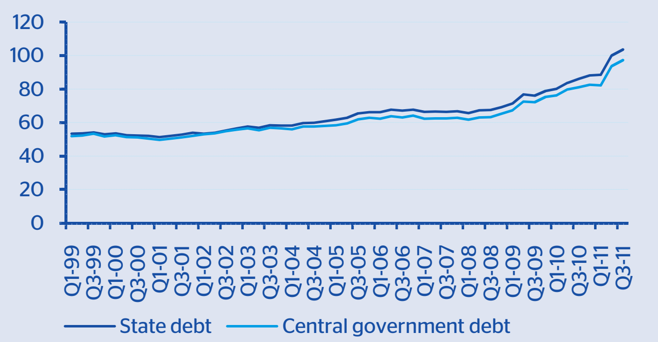
All in all, Portuguese economy will contract in 2011-2012, but could start recovering timidly in 2013. The external sector will remain the driving force of growth and it will manage to make up for the negative effect of a falling domestic demand, in spite of the weakening global environment. The government should continue focusing on structural reforms, in order to improve the prospects for growth in the medium term. Unemployment will remain high, corporate investment will need some time to recover, and confidence is weak, but under continued structural reforms it should start improving in the near future.

Chart 31
Portugal: budget execution, central administration and social security funds (% of GDP)



Source: DGO, Haver and BBVA Research

Chart 32
Portugal: public debt (% of GDP)



Source: BdP and DGO

Box 6. A model to predict the short-term GDP growth in the Portuguese economy: the MICA-BBVA model methodology

At times of high uncertainty, having the most up-to-date information on the evolution of the economy is paramount. Economic data are published with a lag, and for instance at this point (first quarter of Q1) we only have information on GDP for the third quarter of 2011 and the advanced forecast for 2011Q4 is expected to be released by the INE (Portuguese national institute of statistics) on February 14th. Given these significant lags it is important to develop models that estimate the evolution of GDP in real time.

For the Portuguese economy, the only such model available to our knowledge up to now is the one developed by Rua (2004), which is used as the coincident indicator of the Bank of Portugal. Using the same variables but a different methodology (see Camacho et al 2009ab, 2010 and 2011) we have developed an alternative model based on dynamic factor analysis to obtain a real-time synthetic monthly indicator of the economic activity in Portugal.

One of the main advantages of the model comes from the fact that it combines quarterly and monthly frequency data that are published with different delays with respect to the period they refer to, allowing us to compute real-time backcasts, nowcasts and forecasts on the basis of timely updated data for GDP and all other indicators included in the model. In addition, our model differs from the one developed by the Bank of Portugal in that our aim is to predict as accurately as possible the GDP growth, while Rua's model is focused on predicting the trend of such a series.

Methodological description

The dynamic factor model used is based on the idea that economic indicators share a common business cycle component such that they exhibit high statistical correlation with the GDP growth rate. In addition to the correlation criteria, the economic indicators should refer to data of the quarter to predict GDP before the official figure becomes available, and they may be relevant in the model from both a theoretical and an empirical point of view. Thus the evolution of each of the indicators i for the period t, z_t^i can be decomposed into the sum of two stochastic unobservable components. The first component, x_t, usually called "common factor", includes the combined dynamics of all the indicators and can be identified with the Portuguese economic cycle. The second component, u_t^i, known as the idiosyncratic component, refers to the particular dynamics of indicator i during period t.

$$z_t^i = ß_i x_t + u_t^i$$

The movement of the common and idiosyncratic components is established by autoregressive models of order p and q.

$$x_t = \boldsymbol{\rho}_1 x_{t-1} + ... + \boldsymbol{\rho}_p x_{t-p} + e_t$$

$$u_t^i = d_1^i u^i_{t-1} + ... + \mathrm{d}_q^i u^i_{t-q} + \boldsymbol{\varepsilon}_t^i$$

In this case, e_t and $\boldsymbol{\varepsilon}_t^i$ are non-observable error terms that are assumed independent and not serially correlated. Mariano and Murasawa (2003) propose that if we consider the quarterly series as the weighted sum of its monthly expressions, the above model could be represented in state-space form and estimated by maximum likelihood using the Kalman.

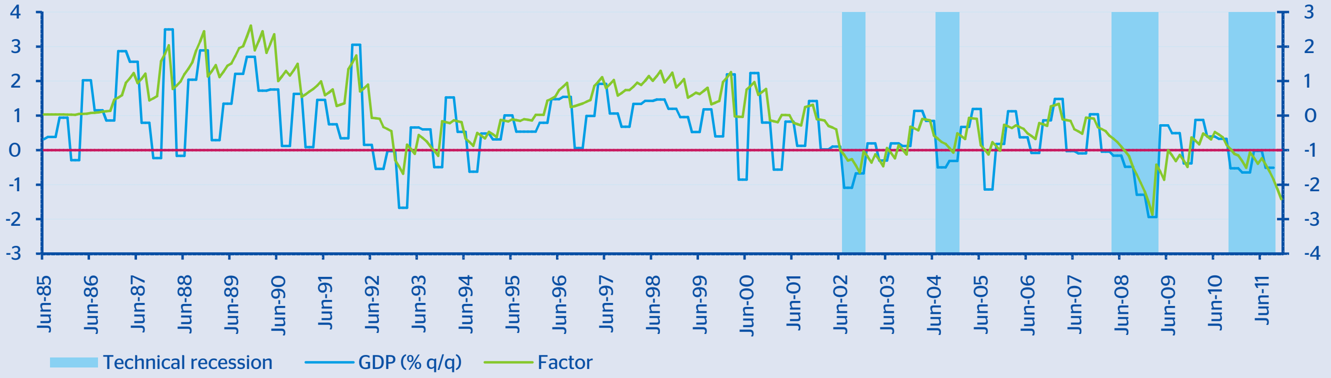
Results

The volatility of both GDP and economic indicators in Portugal is very high, and therefore finding the right indicators and model to predict GDP is non-trivial. Hence, we have decided to start from the indicators selected by Rua in a first stage. Using the same indicators allows us also to compare the performance of both models. The set of indicators includes retail sales (in volume), sales of heavy commercial vehicles, cement sales, the manufacturing production index, households' financial situation, new job vacancies and an external activity proxy, in addition to the GDP. This set of indicators should be sufficient to reflect recent developments in major sectors of the economy.

If we apply the model described above to data for the Portuguese economy, the estimate of the common factor reflects the economic cycles, despite the high volatility of GDP series (mostly at the beginning of the sample). In addition, our indicator also reflects properly the recession stages in Portugal, defined as two consecutive quarters of falling GDP (Chart 33). As observed in Chart 33, recent estimates of the common factor point to a similar recession to the one observed in 2009.

Finally, we must emphasize that this short-run growth model is still work-in-progress. Next steps will consider new indicators, possibly including financial variables to catch up the interlink between financial conditions and real economy.

Chart 33
Portugal: GDP and MICA model indicator



Source: INE and BBVA Research

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4. Tables

Table 3
Eurozone forecasts

(YoY)	2009	2010	2011	2012	2013
GDP at constant prices	-4.2	1.8	1.5	-0.5	1.0
Private consumption	-1.1	0.8	0.2	-0.2	0.8
Public consumption	2.5	0.6	0.1	-0.4	0.5
Gross Fixed Capital Formation	-11.9	-0.7	1.8	-2.6	1.5
Inventories (*)	-0.8	0.5	0.1	0.0	0.0
Domestic Demand (*)	-3.5	1.0	1.0	0.8	0.9
Exports (goods and services)	-12.8	11.3	6.8	2.6	3.3
Imports (goods and services)	-11.6	9.5	4.8	2.1	3.1
External Demand (*)	-0.7	0.8	0.7	0.3	0.1
Prices and Costs					
CPI	0.3	1.6	2.7	1.8	1.3
CPI Core	1.3	1.0	1.7	1.7	1.4
Labour Market					
Employment	-1.8	-0.5	0.5	-0.2	0.3
Unemployment rate (% of labour force)	9.6	10.1	10.1	10.6	10.5
Public Sector					
Surplus (+) / Deficit (-) (% GDP)	-6.4	-6.2	-4.1	-3.0	-1.9
External Sector					
Current Account Balance (% GDP)	-0.1	0.1	0.0	-0.1	0.4

(*) Contribution to GDP growth
Source: BBVA Research

Table 4
Macroeconomic Forecasts: Gross Domestic Product (by country)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.5	3.0	1.7	2.3	2.2
EMU	-4.2	1.8	1.6	-0.5	1.0
Germany	-5.1	3.6	3.0	0.5	1.7
France	-2.6	1.4	1.6	0.2	1.4
Italy	-5.1	1.4	0.4	-1.5	0.2
Spain	-3.7	-0.1	0.7	-1.3	0.6
UK	-4.4	2.1	0.9	0.5	1.4
Latin America *	-0.6	6.6	4.5	3.7	4.1
Mexico	-6.1	5.4	3.8	3.3	2.9
EAGLES **	4.0	8.4	6.7	5.9	6.5
Turkey	-4.9	9.2	8.5	1.9	4.2
Asia Pacific	4.2	8.1	5.8	5.8	6.1
China	9.2	10.4	9.2	8.3	8.7
Asia (exc. China)	1.0	6.7	3.5	4.2	4.4
World	-0.6	5.1	3.9	3.5	4.1

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 5

Macroeconomic Forecasts: Inflation (Avg. by country)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	3.2	2.3	2.3
EMU	0.3	1.6	2.7	1.8	1.3
Germany	0.2	1.2	2.3	1.8	1.3
France	0.1	1.6	2.1	1.6	1.2
Italy	0.8	1.5	2.8	2.2	1.5
Spain	-0.3	1.8	3.2	1.2	1.1
UK	2.2	3.3	4.5	2.8	1.9
Latin America *	6.9	7.4	10.0	9.5	9.1
Mexico	5.3	4.2	3.4	4.0	3.3
EAGLES **	2.8	5.3	6.3	4.8	4.7
Turkey	6.3	8.6	6.7	9.1	6.0
Asia Pacific	0.3	3.6	4.8	3.3	3.4
China	-0.8	3.3	5.4	3.3	3.7
Asia (exc. China)	1.1	3.7	4.4	3.2	3.1
World	2.2	3.5	5.1	3.9	3.6

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Current Account (% GDP, by country)

	2009	2010	2011	2012	2013
United States	-2.7	-3.3	-3.2	-3.1	-3.2
EMU	-0.5	-0.5	0.0	-0.1	0.4
Germany	5.6	5.7	5.3	4.6	4.4
France	-1.5	-1.7	-2.4	-3.4	-2.7
Italy	-2.0	-3.5	-3.6	-3.5	-3.0
Spain	-5.2	-4.5	-4.3	-3.5	-1.1
UK	-1.7	-2.5	-2.5	-0.9	-0.2
Latin America *	-0.3	-0.8	-0.6	-2.0	-2.2
Mexico	-0.7	-0.5	-1.0	-1.1	-1.1
EAGLES **	2.4	2.1	1.4	1.2	1.1
Turkey	-2.2	-6.4	-10.2	-8.0	-7.8
Asia Pacific	3.5	3.4	2.5	2.4	2.5
China	5.2	5.2	4.5	4.5	4.5
Asia (exc. China)	2.3	2.2	1.1	1.1	1.2

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Government Deficit (% GDP, by country)

	2009	2010	2011	2012	2013
United States	-9.9	-8.9	-8.5	-7.1	-4.6
EMU	-6.4	-6.2	-4.2	-3.0	-2.0
Germany	-3.2	-4.3	-1.2	-0.7	0.0
France	-7.5	-7.1	-5.5	-4.7	-3.4
Italy	-5.4	-4.6	-4.0	-2.4	-1.0
Spain	-11.1	-9.2	-8.2	-5.3	-3.3
UK	-11.5	-10.3	-8.0	-6.4	-4.8
Latin America *	-2.8	-2.0	-1.9	-2.1	-1.4
Mexico	-2.6	-3.5	-3.0	-3.0	-2.8
EAGLES **	-3.9	-2.9	-2.4	-2.6	-2.4
Turkey	-5.5	-3.6	-1.4	-2.0	-1.7
Asia Pacific	-4.8	-3.9	-3.9	-3.7	-3.2
China	-2.8	-2.5	-1.5	-1.8	-1.8
Asia (exc. China)	-6.1	-4.8	-5.5	-5.0	-4.2

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 8

Financial Variables

Official Interest Rates (End period)	2009	2010	2011	2012	2013
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.10	0.75	0.75
China	5.31	5.81	6.56	6.06	6.56
10-year Interest Rates (Avg.)					
United States	3.2	3.2	2.8	2.3	2.7
EMU	3.3	2.8	2.6	2.2	2.7
Exchange Rates (Avg.) (US Dollar per national currency)					
United States (EUR per USD)	0.72	0.76	0.72	0.80	0.79
EMU	1.39	1.33	1.39	1.26	1.27
UK	1.56	1.55	1.60	1.59	1.64
China (RMB per USD)	6.83	6.77	6.46	6.25	5.94

Forecast closing date: January 31, 2012
Source: BBVA Research

Table 9

Germany: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	0.5	0.0	0.6	1.3	0.7	1.4
Public consumption	3.1	3.3	1.7	1.3	0.4	0.7
Gross Fixed Capital Formation	1.0	-11.4	5.2	7.0	1.1	4.1
Inventories (*)	0.0	-0.9	0.6	-0.1	0.0	0.0
Domestic Demand (*)	**1.0**	**-2.3**	**2.2**	**2.1**	**0.6**	**1.7**
Export	2.1	-13.6	13.4	8.9	4.1	5.3
Import	3.0	-9.2	11.5	7.9	4.8	6.2
Net export (*)	**-0.2**	**-2.8**	**1.4**	**0.9**	**0.0**	**-0.1**
GDP	**0.8**	**-5.1**	**3.6**	**3.0**	**0.5**	**1.7**
Inflation	**2.8**	**0.2**	**1.2**	**2.5**	**1.8**	**1.3**

(*) Contribution to growth
Source: BBVA Research

Table 10

France: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	0.2	0.2	1.4	0.3	0.3	1.1
Public consumption	1.2	2.3	1.2	0.8	-0.1	0.6
Gross Fixed Capital Formation	0.1	-8.8	-1.4	2.6	-0.4	1.8
Inventories (*)	0.3	-1.3	0.5	1.0	0.0	0.0
Domestic Demand (*)	**0.1**	**-2.4**	**1.3**	**1.9**	**0.1**	**1.1**
Export	-0.6	-12.2	9.3	4.6	3.4	5.1
Import	0.6	-10.6	8.2	5.3	2.8	4.6
Net export (*)	**-0.3**	**-0.2**	**0.1**	**-0.3**	**0.1**	**0.0**
GDP	**-0.2**	**-2.6**	**1.4**	**1.6**	**0.2**	**1.2**
Inflation	**3.2**	**0.1**	**1.7**	**2.3**	**1.6**	**1.2**

(*) Contribution to growth
Source: BBVA Research

Table 11

Italy: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-0.8	-1.6	1.1	0.4	-1.5	-0.4
Public consumption	0.6	1.0	-0.5	-0.4	-1.3	-0.8
Gross Fixed Capital Formation	-3.8	-11.7	2.3	-0.8	-4.2	0.3
Inventories (*)	0.0	-0.7	0.7	-0.9	0.0	0.0
Domestic Demand (*)	**-1.2**	**-3.8**	**1.6**	**-0.9**	**-2.0**	**-0.4**
Export	-2.8	-17.7	12.0	6.4	1.5	2.9
Import	-2.9	-13.6	12.4	1.4	-0.4	1.7
Net export (*)	**0.0**	**-1.2**	**-0.2**	**1.3**	**0.5**	**0.4**
GDP	**-1.2**	**-5.1**	**1.4**	**0.4**	**-1.5**	**0.0**
Inflation	**3.5**	**0.8**	**1.6**	**2.9**	**2.2**	**1.5**

(*) Contribution to growth
Source: BBVA Research

Table 12

Portugal: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	1.3	-2.3	2.1	-3.7	-5.4	-1.0
Public consumption	0.3	4.7	0.9	-3.5	-3.3	-1.4
Gross Fixed Capital Formation	-0.3	-8.6	-4.1	-10.2	-12.7	-0.4
Inventories (*)	0.0	-1.1	0.1	-0.3	0.0	0.0
Domestic Demand (*)	**0.9**	**-3.6**	**0.8**	**-5.6**	**-6.6**	**-0.9**
Export	-0.1	-10.9	8.8	8.0	4.4	4.7
Import	2.3	-10.0	5.4	-3.7	-5.8	0.8
Net export (*)	**-1.0**	**0.6**	**0.5**	**4.0**	**3.9**	**1.5**
GDP	**-0.1**	**-2.9**	**1.4**	**-1.5**	**-2.7**	**0.6**
Inflation	**2.7**	**-0.9**	**1.4**	**3.6**	**2.8**	**1.1**

(*) Contribution to growth
Source: BBVA Research

Table 13

Spain: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-0.6	-4.3	0.8	0.0	-2.0	-0.9
Public consumption	5.9	3.8	0.2	-1.2	-3.1	-1.8
Gross Fixed Capital Formation	-4.7	-16.5	-6.2	-4.6	-6.3	-1.9
Equipment and other products	-2.8	-22.0	5.3	2.1	-5.0	2.1
Construction	-5.7	-15.4	-10.1	-7.6	-7.3	-4.0
Housing	-9.1	-22.0	-9.8	-4.8	-6.5	-1.5
Other construction	-1.6	-7.7	-10.4	-10.2	-8.0	-6.5
Inventories (*)	0.1	0.0	0.0	0.1	0.0	0.0
Domestic Demand (*)	-0.5	-6.5	-1.0	-1.3	-3.2	-1.3
Export	**-1.0**	**-10.2**	**13.5**	**9.2**	**1.6**	**8.2**
Import	-5.1	-16.9	8.9	1.6	-4.8	2.1
Net export (*)	1.4	2.8	0.9	2.0	1.9	1.9
GDP	**0.9**	**-3.7**	**-0.1**	**0.7**	**-1.3**	**0.6**
Inflation	**4.1**	**-0.3**	**1.8**	**3.2**	**1.2**	**1.1**

(*) Contribution to growth
Source: BBVA Research

Table 14

UK: GDP growth and inflation forecasts

YoY rate	2008	2009	2010	2011	2012	2013
Private consumption	-1.5	-3.5	1.2	-0.5	0.3	1.3
Public consumption	1.6	0.0	1.5	0.9	-0.5	-1.7
Gross Fixed Capital Formation	-4.8	-13.4	3.1	-2.4	-0.4	2.1
Inventories (*)	-0.4	-1.0	1.3	0.4	0.4	0.5
Domestic Demand (*)	**-1.9**	**-5.5**	**2.9**	**-0.1**	**0.5**	**1.2**
Export	1.3	-9.5	7.4	4.7	2.2	3.7
Import	-1.2	-12.2	8.6	1.5	1.9	2.8
Net export (*)	**0.8**	**1.1**	**-0.5**	**0.9**	**0.1**	**0.2**
GDP	**-1.1**	**-4.4**	**2.1**	**0.9**	**0.5**	**1.4**
Inflation	**3.6**	**2.2**	**3.3**	**4.4**	**2.8**	**1.9**

(*) Contribution to growth
Source: BBVA Research

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